

Report of the Working Group on

**Introduction of
Financial Holding Company
Structure in India**



**Reserve Bank of India
May 2011**



भारतीय रिज़र्व बैंक
RESERVE BANK OF INDIA

www.rbi.org.in

Letter of Transmittal

Dr. D. Subbarao
Governor
Reserve Bank of India
Mumbai

May 4, 2011

Dear Sir,

**Working Group on
Introduction of Financial Holding Company Structure in India**

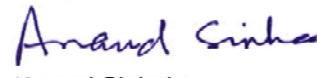
We have immense pleasure in submitting the report of the Working Group appointed vide Memorandum dated June 29, 2010 to recommend a roadmap for the introduction of holding company structure in the Indian financial sector together with the required regulatory, supervisory and legislative framework. The report aims to serve as a guiding document for the introduction of an alternate organizational structure for the banks and identified financial conglomerates in India.

We sincerely thank you for entrusting this responsibility to us.

With kind regards


Yours sincerely,



(Shyamala Gopinath)
Deputy Governor
Chairperson

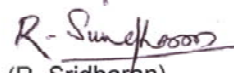

(Anand Sinha)
Member


(Alok Nigam)
Member

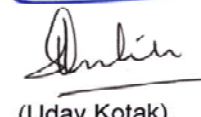

(Prashant Saran)
Member

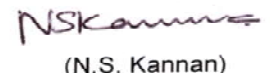

(A. Giridhar)
Member

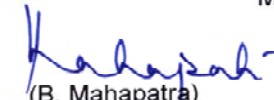

(Dr. K. Ramakrishnan)
Member


(R. Sridharan)
Member


(Keki M. Mistry)
Member


(Uday Kotak)
Member


(N.S. Kannan)
Member


(B. Mahapatra)
Member Secretary

वैकिंग परिचालन और विकास विभाग, 12वीं मंजिल, केन्द्रीय कार्यालय भवन, शहीद भगतसिंह मार्ग, फोर्ट, मुम्बई - 400 001.
फोन : (022) 2266 1602 / 2260 1000 फैक्स : (022) 2270 5691 / 2270 5693

Department of Banking Operations & Development, 12th Floor, Central Office Building, Shahid Bhagat Singh Marg, Fort, Mumbai-400 001.
Tel : (022) 2266 1602 / 2260 1000 Fax : (022) 2270 5691 / 2270 5693

हिंदी आसान है, इसका प्रयोग बढ़ाइए

Table of Contents

		Page No.
	Approach and Recommendations	4
Chapter 1	Introduction	18
Chapter 2	Existing Regulatory and Supervisory Framework for Financial Conglomerates under Bank-Subsidiary Model in India	24
Chapter 3	Various Models of Conglomeration – Assessment	37
Chapter 4	Legal Framework for Financial Holding Companies	46
Chapter 5	Elements of Regulatory and Supervisory Frameworks for Financial Holding Companies in India	57
Chapter 6	Operationalisation of the Framework and Transition Issues	70
Annex 1	Evolution of BHCs and FHCs in the USA	76
Annex 2	Approach to Regulation of FHCs in the USA	83

Approach and Recommendations

1. The Reserve Bank of India (RBI) had constituted a Working Group in June 2010 to examine the feasibility of introducing a Financial Holding Company Structure in India under the chairpersonship of Smt. Shyamala Gopinath, Deputy Governor, RBI. The Working Group held six meetings and deliberated upon the various issues in the light of the practices prevailing in other jurisdictions in regard to regulation and supervision of Financial Holding Companies (FHCs), particularly in the USA. A summary of major observations, approach and recommendations of the Working Group is set out below.
2. The issue of the nature of corporate form adopted by financial groups in India for undertaking various financial activities has acquired relevance from two distinct, though inter-related, perspectives – one, efficient corporate management within the groups addressing the growth and capital requirements of different entities; and two, the degree of regulatory comfort with different models, particularly in regard to the concerns relating to contagion risks. Banks, at present, in India are organized under the Bank-Subsidiary Model (BSM) in which the bank is the parent of all the subsidiaries of the group. The Working Group was mandated to examine the need and feasibility of introducing a financial holding company model in the Indian context, including by drawing lessons from the global financial crisis.

International experience

3. Internationally, the commonly prevalent models under which financial conglomerates are organised straddle the entire spectrum, including a holding company model, wherein all bank as well as non-bank financial activities are undertaken through separate subsidiaries of a parent holding company; a bank-subsubsidiary model which entails banks floating subsidiaries under them to

undertake various non-bank financial activities; and a universal banking model wherein all financial activities are undertaken within a single entity.

4. The international experience indicates that, except in the US where the holding company structure is the dominant form, in other major jurisdictions multiple forms are prevalent, including a holding company structure. The specific structures have evolved in response to the nature of conglomeration across financial segments and their regulation. In the US, the Financial Services Modernization Act of 1999 (GLB Act) allowed financial service providers to be organized as FHCs offering banking, insurance, securities and other financial services, which hitherto banks/bank holding companies were not permitted to undertake. In the EU, financial conglomerates can be organized through a holding company model and the parent entity can be a regulated entity itself, such as a bank or an insurance company, or a non-financial holding company. Australia permitted the holding company structure as part of liberalization of the range of activities that can be carried out within a conglomerate group containing banks, based on recommendations of the Wallis Commission. In Korea, it was the Asian crisis which triggered the move towards the holding company model in the financial sector.
5. The recent global financial crisis can be said to be model agnostic as far as the form of conglomeration is concerned. The FHC model in the US could not ensure isolation of banks from non-bank financial activities – the SPV structure enabled banks to undertake many activities directly. In the EU, on the other hand, where the Bank-Subsidiary model was more prevalent, the inadequacies of consolidated capital requirements at the bank level became evident. Under the Basel framework, all material holdings of banks were required to be deducted from the banks' capital. However, several national discretions led to dilution of this principle – definition of materiality, capital deduction split across Tiers I and II etc. Basel III proposes to address some of these issues.

6. The post crisis reform proposals do not specify preference for any particular model. The focus, as far as structure is concerned, is on strengthening capital requirements at the consolidated level; reducing complexity of structures to enable efficient resolution of financial institutions; and separation of investment banking from commercial banking.

Assessment of various models in the Indian context

7. The Working Group approached the issue from two fundamental perspectives: first, the risk to bank balance sheets from affiliate non-bank entities and second, the regulatory oversight of financial groups from a systemic perspective.

Risk to bank balance sheets

8. The Working Group recognised that while the issues of conflict of interest and moral hazard arising from affiliation are there for all financial sector entities, these are most pronounced in the case of banks on account of the safety net considerations. The risks from affiliation of banks with non-bank financial activities give rise to the following issues:

(i) Which are the activities banks can be permitted to undertake directly or indirectly?

The activities that are permitted to be undertaken by a bank in India are statutorily bounded in terms of Section 6 (1) of the Banking Regulation Act. Within this broad scope, RBI can take a decision on activities that can be allowed to be undertaken by the bank. Banks can either undertake these activities departmentally or RBI may require these to be undertaken through a separate subsidiary. The natural implication of this position is that (i) the activities which a bank cannot undertake directly, it can also not undertake through a subsidiary route and (ii) some activities are allowed only through a subsidiary form of organisation. Thus the universe of activities permitted

through a subsidiary route is already defined. An incidental issue that has arisen is whether a bank should be permitted through a subsidiary form to undertake activities which can be done departmentally. Clearly this results in regulatory arbitrage particularly for those activities that involve leverage since only banks are required to maintain CRR/SLR.

(ii) Having prescribed the activities, which should be the preferred corporate model for undertaking these activities?

The issue, then, is about the nature of the corporate form through which these activities are undertaken by the bank and the regulatory comfort with various models. Historically, all non-bank activities have been undertaken by banks in India through a subsidiary route – i.e. the bank itself floating separate subsidiaries. Even though the Bank-Subsidiary Model followed in India is also followed internationally in some countries, generally it is believed that such an arrangement unduly concentrates the burden of corporate management of the group and equity infusions in future arising from expansion of business and to meet the regulatory capital requirement in the bank. From the groups' perspective, such a model also constrains the ability of the shareholders of the parent bank to unlock the value of the parent's holdings in various subsidiaries.

From a regulatory perspective, one of the key risks posed by the Bank-Subsidiary Model is that the parent bank is directly exposed to the functioning of various subsidiaries and any losses incurred by the subsidiaries inevitably impact the bank balance sheet. It therefore becomes imperative that the bank regulator has an interest in the health of all subsidiaries under the banks, even as each subsidiary is under the jurisdiction of the respective sectoral regulators. The most obvious risk from affiliation of banks with non-banks is the risk of transference to non-bank affiliates of a subsidy implicit for banks in the safety net, deposit insurance, access to central bank liquidity and access to payment systems, with the attendant moral hazard. This subsidy is more

readily transferred to a subsidiary of bank and can, to a certain extent, be reduced through the holding company structure.

The other risk posed by this model is the difficulty in resolution if the bank, or any of its subsidiaries, is in trouble.

Systemic oversight of financial groups

9. The functional regulatory model in the financial sector in India has implied an entity-focused regulation by the sectoral regulators. Consolidated supervision for groups having cross-sectoral presence has been attempted through the conglomerate supervision framework which envisages closer oversight of identified conglomerates.
10. The Working Group felt that a holding company structure may enable a better oversight of financial groups from a systemic perspective. It would also be in consonance with the emerging post-crisis consensus of having an identified systemic regulator responsible *inter alia* for oversight of systemically important financial institutions (SIFIs). A holding company model would provide the requisite differentiation in regulatory approach for the holding company *vis-à-vis* the individual entities.
11. The Working Group, therefore, concluded that on balance, a holding company model may be more suited in the Indian context. It, however, was conscious of the fact that regardless of the organizational forms, banks cannot be totally insulated from the risks of non-banking activities undertaken by their affiliates. The Working Group also recognized that there are divergent ownership and governance norms for various sectors and also entities within the sectors. These divergences primarily reflect regulatory and public policy objectives. There are also legacy issues concerning the existing conglomerates. Any framework to harmonise them at the level of the FHC would be a challenge and therefore the FHC as a preferred model will need to be phased in gradually.

12. The Working Group has, therefore, divided its recommendation in two parts: the first set of recommendations pertains to operationalisation of a full-fledged FHC framework and the second set of recommendations contains the operational arrangements till the full fledged FHC framework is achieved.

A. Recommendations for moving to a full-fledged FHC Framework

13. The Working Group was of the view that the FHC model should be preferred model for all financial groups – irrespective of whether they contain a bank or not. Financial groups without banks could also be of systemic importance particularly if they are large and undertake maturity and liquidity transformation. This would be particularly relevant in the case of large conglomerates coming under the existing financial conglomerate supervision framework.

Recommendation 1: The Financial Holding Company (FHC) model should be pursued as a preferred model for the financial sector in India.

Recommendation 2: The FHC model can be extended to all large financial groups – irrespective of whether they contain a bank or not. Therefore, there can be Banking FHCs controlling a bank and Non-banking FHCs which do not contain a bank in the group.

Regulatory Framework for FHCs

14. The Working Group considered various possible options in this regard and concluded that a separate regulatory framework for financial holding companies, overarching the existing functional regulation for various segments, would be the most desirable alternative. An umbrella supervisory authority would be essential to assess how risks to one part of a financial holding company may be affected by risks in the other parts of the holding company structure and the overarching

need of safety and soundness of the system as a whole and the payment system. While firewall provisions can be important safeguards in preventing potential conflicts of interest and protecting insured deposits, in reality the firewalls may not hold up. Such an oversight framework would also ensure there is no "product arbitrage" across different functional regulatory regimes. However, the Working Group was very clear that the role of the financial holding company regulator would be supplementary to the role of existing functional regulators.

Recommendation 3: There should be a separate regulatory framework for financial holding companies.

15. As regards the legal framework for separate regulation of FHCs, the Working Group examined various options and concluded that enactment of a separate Act for regulation would be the most efficient alternative for the following reasons:

- It will avoid any legal uncertainties that could be there if FHCs were to be governed by amending RBI Act or BR Act;
- It will align the regulation of FHCs with the objectives of systemic oversight; and
- It will enable design of a regulatory framework for FHCs different in scope and focus from entity regulation.

Recommendation 4: A separate new Act for regulation of financial holding companies should be enacted.

Recommendation 5: Amendments should also be simultaneously made to other statutes/Acts governing public sector banks, Companies Act and others, wherever necessary. Alternatively, in order to avoid separate legislation for amending all individual Acts, the provisions of the new Act for FHCs should have the effect of amending all the relevant provisions of individual Acts and have over-riding powers over other Acts in case of any conflict.

Who should regulate the financial holding company?

16. The Working Group was of the uniform view that given the implicit mandate of the central banks in financial stability and monitoring systemic risks, it would be imperative in the Indian context to vest the responsibility of regulating the financial holding companies with the Reserve Bank. The Reserve Bank would be best suited to design a separate framework for regulating the financial holding companies, with discernibly different focus from the regulation of banks.

Recommendation 6: The Reserve Bank should be designated as the regulator for financial holding companies.

Recommendation 7: The function of FHC regulation should be undertaken by a separate unit within RBI with staff drawn from both RBI as well as other regulators.

Recommendation 8: The new FHC regulatory framework should also formalize a consolidated supervision mechanism through Memorandum of Understanding between regulators.

What should be the elements of the regulatory framework for FHCs?

Recommendation 9: Intermediate holding companies within the FHC should not be permitted due to their contribution to the opacity and complexity in the organizational structure.

Recommendation 10: The FHC should primarily be a non-operating entity and should be permitted only limited leverage as stipulated by RBI. However, it could carry out activities which are incidental to its functioning as an FHC.

Recommendation 11: The FHCs should be permitted to carry out all financial activities through subsidiaries. The activities in which the FHCs should not engage or should engage only upto a limit, e.g. commercial activities, should be stipulated by RBI.

Recommendation 12: The FHC should be well diversified and subject to strict ownership and governance norms. The ownership restrictions could be applied either at the level of their FHCs or at the entity level, depending upon whether the promoters intend to maintain majority control in the subsidiaries wherever it is permissible as per law.

Recommendation 13: Appropriate limits should be fixed on cross-holding between different FHCs. There should also be limits on cross holding between FHCs on one hand and banks, NBFCs, and other financial institutions outside the group. The cross holding among the entities within the FHC group may be subjected to intra-group transactions and exposure norms.

Recommendation 14: It would be necessary to put in place some limit on the expansion of non-banking business after the existing financial groups dominated by the banks migrate to holding company structure (Banking FHCs) so that the banking business continues to remain the dominant activity of the group and growth of banking is not compromised by these groups in favour of growth of non-banking business. Presently, under the BSM, the banks' total investment in their subsidiaries is capped at 20% of banks' net worth. Under the FHC structure, the allocation of equity capital by Banking FHCs to non-banking subsidiaries should also be capped at a limit as deemed appropriate by RBI to ensure that the banking continue to be a dominant activity of the group.

Recommendation 15: If the holding company is to function as an anchor for capital support for all its subsidiaries, requisite space needs to be provided to the holding company for capital raising for its subsidiaries. In this context, it is possible to envisage to have either a listed holding company with all its subsidiaries being unlisted or both the holding company with all or some of its subsidiaries being listed depending on the objectives and strategy of the financial group and the prevailing laws and regulations on investment limits. Given the circumstances prevailing in India, listing can be allowed both at the FHC level as well as the subsidiary level subject to suitable safeguards and governance/ownership norms prescribed by the regulator/s from time to time.

Public Sector Banks

17. There is the constraint of minimum Government shareholding of 51% in the public sector banks (PSBs).

Option I: Government holding in PSBs gets transferred to a holding company, which also holds shares in demerged bank subsidiaries.

- Because of the need for the Government to hold minimum 51% in the bank, this option will require the FHC to be listed while the banking subsidiary can remain unlisted.
- Government would have to continue to support capital requirements of the bank as well as non-bank subsidiaries.

Option II: Government continues to hold directly in the bank while shareholding of all private shareholders gets transferred to holding company. The holding company will also hold shares in the demerged bank subsidiaries.

- Government would be required to support only the capital requirements of the bank.

- Government could encash the value of indirect shareholding in bank subsidiaries. Post FHC, the Government could continue to hold, in addition to 51% in the bank, shares in various subsidiaries directly equivalent to its existing indirect holding. Since there is no requirement of minimum holding in these entities, there will not be any need for Government to provide capital.
- The holding company would, effectively, not be a holding company in the sense that it would not be holding controlling stake in the bank. The shareholder dynamics in such a case needs to be examined since there will be two large shareholders viz. the holding company and the government. Although, the public sector character of banks would not get compromised and existing government powers can continue to be exercised, the challenge will be governance of the bank with two blocks of directors who could have differing interests.

Taxation issues

18. Transition from the existing Bank-Subsidiary Model to FHC model would involve demerger of various bank subsidiaries and transfer of ownership from the bank level to the FHC level. The Working Group recommends that suitable amendments may be made in the Income Tax Act and stamp duty laws to make this one-time transition tax and stamp duty neutral for all entities involved. It may also be ensured that post-FHC, dividend distribution tax regime does not apply to upstreaming of dividends to the FHC level purely for the purpose of investment in other affiliates. This dispensation is justified in the case of financial entities in view of the minimum capital and capital adequacy regulations.

Recommendation 16: Suitable amendments to various taxation provisions may be made to make the transition from Bank-Subsidiary Model to FHC model tax and stamp duty neutral.

Recommendation 17: Dividends paid by subsidiaries to the FHC may be exempt from the Dividend Distribution Tax (DDT) to the extent these dividends are used by the FHC for investment in other subsidiaries.

B. Operational Arrangements till the Enactment of the FHC Act

19. The Working Group recognises the challenges in the process of enactment of a new Act and is cognizant of the fact that it will be a while before this can be achieved, presuming the recommendations are accepted by all stakeholders. Further, there are complex legacy and policy issues concerning various financial sectors, viz., banking, insurance, securities activities etc., which may constrain a clean transition to the FHC model at a systemic level. The Working Group also recognises that it may not be possible for the existing financial groups to make a transition to the FHC model unless suitable amendments to various Acts are made to make the transition from existing BSM model to FHC model tax and stamp duty neutral. The Working Group, therefore, concluded that the FHC model may have to be phased in gradually over a period taking into account the specific challenges. Such a calibrated approach, it was recognised, will need to give a greater leeway to the existing groups for adoption of the FHC model as compared to new ventures in banking or insurance. Any new regulatory framework can be applied prospectively for new entities and in regard to existing entities it has to be a calibrated approach. Accordingly, the Working Group recommends the following operational scheme:

- (i) Pending enactment of a separate Act, the FHC model may be operationalised under the provisions contained in the RBI Act. The FHC, accordingly, will be registered as an NBFC with the RBI and the RBI will frame a suitable regulatory framework for FHCs in consultation with other regulators.

- (ii) All identified financial conglomerates having a bank within the group will need to convert to the FHC model in a time bound manner, once the pre-requisites necessary to make the transition tax neutral are in place.

- (iii) In cases the above conglomerates do not want to convert to FHCs, they should be required to confine only to those activities which the banks are presently permitted by RBI to undertake departmentally. This would mean that such conglomerates should eventually divest their holding in the subsidiaries.

- (iv) For all other banking groups, conversion to the FHC model may be optional till the enactment of the FHC Act.

- (v) All non-banking financial conglomerates may have the option to convert to the FHC model. Those having insurance companies and do not adopt the FHC model should comply with the extant regulations regarding promoters stipulated by IRDA.

- (vi) All new banks and insurance companies, as and when licensed, will mandatorily need to operate under the FHC framework. For new banks, the Group recommends that:
 - a. The promoter/s would be required to float a new holding company which would initially be 100% owned by the promoter/s and have the new banks as its wholly owned subsidiary.
 - b. All the ownership norms, as prescribed in the licensing conditions, would be made applicable either at the FHC level or at the bank level.

- c. In case the promoter entity/ies already have a non-bank financial subsidiary, such subsidiaries would be brought under the holding company in a phased manner.
- (vii) Amendments to various taxation provisions to make the transition from Bank-Subsidiary model to FHC model tax neutral would be a binding condition for operationalising this framework.

Chapter 1

Introduction

1.1 Over the last two decades, India has seen the emergence of Financial Conglomerates (FCs), i.e., financial services groups comprising a number of legal entities each operating in a different segment of the financial services sector. This has been due to the progressive opening up of different parts of the financial sector – banking, investment/ merchant banking, asset management, life insurance, general insurance and so on. As a result, a range of financial groups have evolved in the Indian financial sector, with the apex entity of the conglomerate generally being an operating financial services entity – a bank, housing finance company, non-banking financial company, insurance company; or, in some cases, an industrial company. Broadly, two types of financial groups can be identified in the Indian financial sector:

- (i) Financial groups with a **bank** at the apex, where the non-banking financial services are normally undertaken by the banking group through the bank's subsidiaries/associates/joint ventures. Generally, the banking business is the dominant activity in such groups.
- (ii) Financial groups with a **non-banking company or an industrial company** at the apex. Generally, barring a few exceptions, these groups do not have a bank as one of their entities and in some cases the financial services may not be the dominant business of these groups.

1.2 There are three forms of organizational structures under which different financial services activities are conducted in the same group:

- The *Universal Bank Model* where all financial services are conducted within the bank;
- The *Parent/Bank Subsidiary Model*, where non-banking activities are conducted in separately constituted subsidiaries of the parent; and

- The *Bank/Financial Holding Company Model*, where non-banking activities are undertaken in firms owned by a parent company that also owns the bank.

1.3 In many countries, deregulation and financial consolidation led to the development of Financial Holding Companies (FHCs) thereby allowing commercial banking, insurance, investment banking, and other financial activities to be conducted under the same corporate umbrella. Thus, FHCs occupy a significant place in the universe of large financial groups. The financial services sector in India has also witnessed growth in the emergence of large and complex financial groups. With the enlargement in the scope of the financial activities driven by the need for diversification of business lines to control the enterprise-wide risk, some of the market players are exploring the structures hitherto unfamiliar in India. In this context, it is considered opportune to examine alternative form of organization which could be made available to Indian financial groups so as to improve their efficiency. Given the experience of the recent financial crisis particularly the losses suffered by large banks due to their off-balance sheet activities, an over-riding consideration while examining such structures would be their amenability to effective regulation and supervision and contribution towards mitigation of risks to the banking affiliates within the groups.

1.4 The first effort made in this regard was the publication of a Discussion Paper on “Holding Companies in Banking Groups” by the RBI (www.rbi.org.in) on August 27, 2007 for public comments. The feedback received on the Discussion Paper underscored the need for introduction of Bank Holding Companies (BHCs)/Financial Holding Companies (FHC) in India to ensure an orderly growth of financial conglomerates and possibly better insulation of a bank from the reputational and other risks of the subsidiaries/affiliates within the group. Later, the Committee on Financial Sector Assessment (CFSA) in its report issued in March 2009 had noted that the absence of the holding company structure in financial conglomerates exposes investors, depositors and and the parent company to risks, strains the parent company’s ability to fund its own core business and could restrict the growth of the subsidiary business.

1.5 Considering the complexity of the issues involved and implications of the BHC/FHC model for the financial system in general and banking system in particular, the Reserve Bank in its Monetary Policy Statement for the year 2010-11 announced to constitute a Working Group to recommend a roadmap for the introduction of a bank holding company structure together with the required legislative amendment/framework. Accordingly, a Working Group was constituted in June 2010 under the Chairpersonship of Smt. Shyamala Gopinath, Deputy Governor, Reserve Bank of India, with the following composition:

(i) Smt. Shyamala Gopinath Deputy Governor, Reserve Bank of India	Chairperson
(ii) Smt. Usha Thorat* Deputy Governor, Reserve Bank of India	Permanent Invitee
(iii) Shri Y.H. Malegam Director, Central Board, Reserve Bank of India	Permanent Invitee
(iv) Shri Anand Sinha** Executive Director, Reserve Bank of India	Member
(v) Shri Alok Nigam Joint Secretary, Department of Financial Services, Government of India, Ministry of Finance	Member
(vi) Shri Prashant Saran Whole Time Member, Securities and Exchange Board of India	Member
(vii) Shri A. Giridhar Executive Director, Insurance Regulatory and Development Authority	Member
(viii) Dr. K. Ramakrishnan Chief Executive, Indian Banks' Association	Member
(ix) Shri R. Sridharan Managing Director & Group Executive, State Bank of India	Member

* Superannuated on November 9, 2010

** Appointed as Deputy Governor w.e.f. January 19, 2011

(x) Shri Keki M. Mistry Vice Chairman and CEO, HDFC Ltd.	Member
(xi) Shri Uday Kotak Vice Chairman & Managing Director Kotak Mahindra Bank Ltd.	Member
(xii) Shri N.S. Kannan Executive Director and CFO, ICICI Bank Ltd.	Member
(xiii) Shri B. Mahapatra Chief General Manager-in-Charge, Reserve Bank of India	Member Secretary

Shri S. B. Mainak, Executive Director, Life Insurance Corporation of India was also invited to the discussions in the meeting held on October 28, 2010 to represent the views of non-banking financial conglomerates.

1.6 The terms of reference assigned to the group were:

- To study the different Holding Company structures internationally in the financial sector;
- To examine these structures including Financial Holding Company structure, their advantages and suitability from the regulatory/supervisory perspective in the Indian context compared to the existing structures in India;
- To recommend a suitable Holding Company framework for India and the required regulatory and supervisory framework;
- To lay a roadmap for adoption of the recommended Holding Company framework;
- To examine the legal and taxation issues involved and suggest enactment of statutes/amendment to the existing statutes; and
- To examine any other relevant issues.

1.7 The Working Group held six meetings¹ and prepared this report after going through the available literature, the practices prevailing in different jurisdictions and taking into account the views of concerned stakeholders in India.

1.8 The Working Group conveys its deep sense of gratitude to Smt. Usha Thorat, former Deputy Governor, RBI who attended a few meetings and Shri Y.H. Malegam, Director, Central Board, RBI who was a permanent invitee to the meetings of the Working Group. The Working Group immensely benefitted from their experience and expertise in the field of financial sector development, and its regulation and supervision. The Working Group would like to place on record its sincere appreciation of their invaluable contribution in bringing out this report. The Working Group also appreciates Shri G.S. Hegde, Principal Legal Adviser, RBI for his commendable valuable support in dealing with the legal issues related to implementation of financial holding company structure in India.

1.9 The Working Group would also like to express its appreciation of the excellent intellectual inputs and support provided by Shri Rajinder Kumar, General Manager, Shri Vaibhav Chaturvedi, Deputy General Manager, Shri Rajnish Kumar, Deputy General Manager, Shri Rakesh Kumar Barman, Assistant General Manager and Ms. Tariqa Singh, Assistant General Manager of Reserve Bank of India.

1.10 The report is organized in 6 chapters. Chapter 2 elaborates the existing regulatory and supervisory framework for Financial Conglomerates under Bank-Subsidiary Model in India. Chapter 3 makes an assessment of different models, particularly the Financial Holding Companies model vis-à-vis the Bank-Subsidiary Model. Chapter 4 discusses the possible legal framework for operationalising the financial holding company structure in India. Chapter 5 contains the recommendations on the regulatory and supervisory frameworks for FHCs in India. Finally, Chapter 6 identifies the operational

¹ The meetings were held at Mumbai on July 13, September 7, October 28, December 22, 2010, March 29 and May 4, 2011.

and transition issues which need to be addressed to facilitate the transition to the FHC structure.

Chapter 2

Existing Regulatory and Supervisory Framework for Financial Conglomerates under Bank-Subsidiary Model in India

2.1 Introduction

In India, banks have expanded into non-banking activities during the last two decades. The motivations for expansion have been the traditional ones, viz., diversification of risk and enhancement of incomes. Besides, the Indian financial system has been dominated by banks. Therefore, banks have led the non-banking financial sector development and innovation and promoted the financial activities which were capital intensive in nature such as insurance. Over the years, banks have set up subsidiaries almost in all non-banking financial areas such as Mutual Funds, Venture Capital Funds, Pension Funds, NBFCs, Stock Broking, Merchant Banking, Factoring, Insurance, Housing Finance, etc. Even though the non-banking assets of banks do not form very substantial portion of their consolidated balance sheets as compared to their banking assets, RBI has been conscious about the need for putting in appropriate regulatory and supervisory framework for exercising supervision on banks at consolidated level.

2.2 Legal Provisions

The financial activities in which a bank can engage have been enumerated in Section 6(1) of Banking Regulation Act (BR Act), 1949. Banks can set up subsidiaries for carrying out activities only in one or more of these areas. The interpretation of this Section is that a bank cannot undertake the activities not enumerated in this Section on its own balance sheet or through its subsidiaries. As per Section 19(2) of BR Act, no banking company can hold shares in any company, whether as pledgee, mortgagee or absolute owner of an amount exceeding 30% of the paid-up share capital of that

company or 30% of its own paid-up share capital and reserves, whichever is less. Accordingly, it is possible for banks to hold equity in a company engaged in any legal activity including that not enumerated in Section 6(1) of BR Act, giving the bank a significant influence in the affairs of such a company. In addition, as per Section 8 of the BR Act, no banking company can directly or indirectly deal in the buying or selling or bartering of goods, except in connection with the realization of security given to or held by it, or engage in any trade, or buy, sell or barter goods for others otherwise than in connection with bills of exchange received for collection or negotiation or with such of its business as is referred to in clause (i) of sub-section (1) of Section 6. This would be interpreted to mean that a bank can also not set up a subsidiary to engage in the activities prohibited in Section 8. Some banks have been permitted by RBI to set up subsidiaries in non-financial areas to carry out activities which are incidental to their banking business.

2.3 Regulatory Guidelines Issued by RBI

2.3.1 Banks were initially allowed to engage in non-banking financial activities such as leasing, hire purchase, factoring, merchant banking etc. departmentally. However, later on it was considered appropriate for banks to expand into non-banking financial areas through subsidiary route. The bank's equity investments in financial services companies (through subsidiaries or otherwise) should not exceed 10% of bank's paid-up capital and reserves in a single company and 20% of its paid-up capital and reserves in all such companies together. The objective of this limit is to ensure that banks remain engaged predominantly in banking activities. Banks' undue expansion into other activities could increase risk for the banks as the banks may venture in an area in which they do not have much expertise and incur heavy losses jeopardizing the interests of depositors. Besides, too much expansion in other areas may also distract the bank from its core business i.e. banking, which again will not be in the interest of depositors and the economy.

2.3.2 The 'Group-30' Report on 'Financial Reform – A Framework for Financial Stability' released on January 15, 2009 observed that large, systemically important banking institutions should be restricted in undertaking proprietary activities that present particularly high risks and serious conflicts of interest. Sponsorship and management of commingled private pools of capital (that is, hedge and private equity funds in which the banking institutions own capital is commingled with client funds) should ordinarily be prohibited and large proprietary trading should be limited by strict capital and liquidity requirements. In view of this report, as also the losses suffered by banks during financial crisis due to reputational concerns, of late, RBI has shown concerns over some of the banks evincing interest in sponsoring private equity funds and required the concerned banks to treat the investment made by the non-anchor investors in the private equity/ venture capital funds as off-balance sheet exposure with 50% credit conversion factor for the purpose of capital adequacy.

2.3.3 RBI also issued a discussion paper on 'Regulation of Off-Balance Sheet Activities of Banks' on January 8, 2010, in which pros and cons of banks' sponsorship of private equity funds and securitization vehicles were discussed in detail.

2.4 Prudential Norms for Banking Groups

As per Basel II framework, banking groups are groups that engage predominantly in banking activities. The capital adequacy and exposure norms are applicable to banks on consolidated basis. Banks' exposure to their group companies is limited by the extant exposure norms. In particular, Basel II framework including the Pillar 2 is required to be applied on a group-wide basis. To start with, the Pillar 2 would be implemented at solo level with a phased coverage of entire group. A similar approach would be followed in the implementation of the advanced approaches of Basel II. Other risk management guidelines such as those relating to the management of interest rate risk, liquidity risk, stress testing would also be progressively implemented at group

level. Recent enhancement to Basel II guidelines has emphasized enterprise-wide risk management.

2.5 Consolidated Supervision Framework for Financial Groups in India

The consolidated supervision framework for financial groups in India can be divided into two categories:

- (i) The framework for all banks having subsidiaries, and
- (ii) The framework for identified financial conglomerates.

While the supervision framework at (i) above is applicable to all banking groups regardless of their size, the framework at (ii) above is applicable only to identified large financial conglomerates above certain thresholds in their respective market segments. The main elements of the two frameworks are discussed below.

2.5.1 Supervisory Framework for All Banks Having Subsidiaries

2.5.1.1 RBI set up a multi-disciplinary Working Group in November 2000 under the Chairmanship of Shri Vipin Malik, then Director on the Central Board of RBI to examine the feasibility of introducing consolidated accounting and other quantitative methods to facilitate consolidated supervision. The Working Group identified the following three components of consolidated supervision:

- Consolidated financial statements (CFS), which are intended for public disclosure. Accordingly, all banks coming under the purview of consolidated supervision of RBI, whether listed or unlisted were required to prepare and disclose Consolidated Financial Statements from the financial year commencing from April 1, 2002 in addition to solo financial statements;
- Consolidated prudential reports (CPR) for supervisory assessment of risks which may be transmitted to banks (or other supervised entities) by other group members; and
- Application of prudential regulations relating to capital adequacy and large exposures/risk concentration on group basis.

2.5.1.2 Initially, consolidated supervision in India has been mandated for all groups where the controlling entity is a bank. It is envisaged that banks in mixed conglomerates would be brought under consolidated supervision in due course, where:

- i. the parents may be non-financial entities; or
- ii. the parents may be financial entities falling under the jurisdiction of other regulators like Securities and Exchange Board of India or Insurance Regulatory and Development Authority; or
- iii. the supervised institution may not constitute a substantial or significant part of the group.

2.5.1.3 RBI Guidelines mandate that a parent presenting Consolidated Financial Statements should consolidate all subsidiaries - domestic as well as foreign, except those specifically permitted to be excluded under Accounting Standard. The reasons for not consolidating a subsidiary should be disclosed in Consolidated Financial Statements. The responsibility of determining whether a particular entity should be included or not for consolidation would be that of the Management of the parent entity and the Statutory Auditors should comment in this regard if they are of the opinion that an entity which ought to have been consolidated had been omitted. Consolidated Financial Statements should normally include consolidated balance sheet, consolidated statement of profit and loss, Principal Accounting Policies, Notes on Accounts, etc. The Consolidated Supervision Guidelines have been extended to the foreign banks in India in a limited form i.e. preparation of Consolidated Prudential Reports, with effect from April 2007.

2.5.1.4 However, there are certain limitations to the extant consolidated supervision mechanism as below:

- Restricted to only those groups where the parent/controlling entity is a bank;
- Excludes insurance sector;

- At present, Intra-Group Transactions & Exposures (ITEs) are captured only in respect of identified financial conglomerates. ITEs need to be captured as part of consolidated supervision of all banking groups in general;
- Does not envisage any inter-regulatory information sharing; and
- Does not cover non-financial linkages having a bearing on governance.

Due to the above limitations, a need was felt to introduce more broad-based regulatory framework especially for the large complex financial groups. This led to the introduction of monitoring framework for financial conglomerates.

2.5.2 Supervisory Framework for Identified Financial Conglomerates in India

2.5.2.1 Following the Basel Capital Accord and general acceptance of Core Principles for Effective Banking Supervision, the Basel Committee on Banking Supervision (BCBS) in association with International Association of Insurance Supervisors (IAIS) and International Organization of Securities Commissioners (IOSCO), formed the Joint Forum on Financial Conglomerates (Joint Forum), a working group that studied the international practices pertaining to supervision of FCs and recommended supervisory standards for financial conglomerates. These standards became the guiding principles for devising the supervisory framework for FCs in most of the countries. In India also the regulatory and supervisory framework for the financial conglomerates has been developed keeping in view these principles, to the extent permissible under the existing legal provisions.

2.5.2.2 The financial landscape in India has undergone significant changes in past decade as a result of diversification of some of the bigger banks into other financial segments like merchant banking and insurance, emergence of several new players with diversified presence across major segments and possibility of some of the non-banking institutions in the financial sector acquiring the scale large enough to have a systemic impact. Till 2004, the supervisory approach followed by the financial sector regulators in India was focused on the sectoral entities. While stand-alone approach to supervision

facilitated entity-specific supervision, there was a need to ensure smooth flow of supervisory information among the regulators in order to appreciate the potential risks associated with the conglomerate as a whole. The diverse risks arising from conglomeration of banking, insurance and securities firms has necessitated that the respective sectoral supervisors gather/assimilate information on the activities of the subsidiaries/associates which might adversely impact the respective parents. The major concerns/ challenges to the financial sector supervisors emanating from the conglomeration process are:

- a) The moral hazard associated with the 'Too-Big-To-Fail' position of many financial conglomerates;
- b) Contagion or reputation effects on account of the 'holding out' phenomenon; and
- c) Concerns about regulatory arbitrage, non-arm's length dealings, etc. arising out of Intra-group Transactions and Exposures, both financial and non-financial.

2.5.2.3 Accordingly, to address these broad supervisory issues, the three major financial sector supervisors in India (RBI, SEBI and IRDA) established a special monitoring system for Systemically Important Financial Intermediaries (SIFI). The Financial Conglomerate monitoring framework was put in place in June 2004 following the acceptance of the report of an inter-regulatory Working Group (Convenor: Smt. Shyamala Gopinath) on monitoring of Systemically Important Financial Intermediaries (Financial Conglomerates). The FC monitoring framework has been revised in phases in order to enhance its effectiveness. The current practices being followed in regulation of SIFIs/ FCs are as below:

- a) Off-site surveillance through quarterly Returns aimed at tracking the following:
 - ensure compliance of arms length principle in intra-group transactions and exposures (ITEs);
 - identifying entities with deteriorating financials and large risk concentrations;

- large intra-group transactions and risk concentrations manifesting in major markets viz. equity, loans, debt, repo, inter-bank, call money, derivatives, etc. carried out for any purpose (trading or investment);
 - build-up of any disproportionate exposure (both fund based as well as non-fund based) by a regulated entity to other group entities;
 - any group-level concentration of exposure to various financial market segments and counterparties outside the group; and
 - information on adverse events such as fraud, penalty/ strictures etc., levied/ passed by regulators/ courts/ administrative agencies.
- b) Holding of high level half-yearly meetings by the regulator entrusted with the supervision of the conglomerate with the Chief Executive Officers of the major entities in the conglomerate in association with other regulators to address outstanding issues/ supervisory concerns.
- c) Periodic review by a Technical Committee having members from financial market regulators on:
- concerns arising out of analysis of quarterly returns data; and
 - other significant information in the possession of the regulators, which might have a bearing on the conglomerate as a whole.

2.6 Additional Measures Being Implemented in the Supervision of Financial Conglomerates

2.6.1 Renewed Approach Towards Regulation and Supervision of FCs

Some of the specific changes being brought to the regulatory/supervisory framework for the FCs, which is put in place jointly by RBI, SEBI and IRDA, are listed below:

- understanding the risk profiles of the conglomerates' operations;
- improving the efficacy of their risk management systems and the quality of governance;

- monitoring of 'material' intra-group transactions and risk concentrations;
- redefining the criteria for identification of FCs and its group entities on the basis of principles of 'control';
- strengthening the supervisory cooperation and information sharing mechanism;
- revision of the quarterly off-site return submitted by the FCs to the principal regulator to capture more qualitative information about the groups; and
- improving the internal supervisory process for the identified FCs.

2.6.2 Measures Announced in Second Quarter Review of Annual Policy 2010-11

The Reserve Bank had constituted an Internal Group on the Supervision of Financial Conglomerates in India. The Internal Group had made various recommendations for strengthening the supervision of the FCs, including changes in certain regulatory norms. RBI has decided to implement the significant recommendations made by the Group pertaining to capital adequacy and intra-group transactions and exposures for FCs. In addition, RBI has also proposed to review the corporate governance standard in the banks in the light of the 'Principles for Enhancing Corporate Governance' issued by the BCBS in October 2010.

2.6.2.1 Capital Adequacy for FCs

As per Basel II framework, investments in the equity of subsidiaries or significant minority investments in banking, securities and other financial entities, where control does not exist, together with other regulatory capital investment in these entities are required to be excluded from the banking group's capital if these entities are not consolidated. As per the Internal Group recommendation, the threshold of significant influence/ investment may be fixed at 20 per cent instead of the present 30 per cent. Accordingly, RBI has proposed:

- that the entire investments in the paid up equity of the entities (including insurance entities), where such investment exceeds 20 per cent of the paid up equity of such entities shall be deducted at 50 per cent from Tier I and 50 per cent from Tier II capital when these are not consolidated for capital purposes with the bank. In addition, entire investments in other instruments eligible for

regulatory capital status in these entities shall also be deducted at 50 per cent from Tier I and 50 per cent from Tier II capital; and

- the deductions indicated above will also be applicable while computing capital adequacy ratio of the bank on a solo basis.

The capital adequacy requirement needs to be further calibrated after finalization of the Basel III rules.

2.6.2.2 *Intra-Group Transactions and Exposures in FCs*

Intra-group transactions and exposures (ITEs) occur when entities within a corporate group carry out operations among themselves. Supervisory concerns arise when ITEs negatively impact a regulated entity that is part of a financial group. These concerns may rise as the number of unregulated entities in the group increases with growing diversification. ITEs can be used to migrate 'losses' or other unintended outcomes of a regulated entity by parking the same with an unregulated entity and thereby escaping the public's, auditor's and supervisor's scrutiny. Other supervisory concerns include non arm's length dealing, inappropriate transfer of capital / income from regulated to unregulated entities, transfer of risk within the group to the detriment of regulated entities. Effective risk assessment of financial conglomerates requires careful monitoring of intra-group exposures, and where necessary putting in place appropriate limits on such exposures in the regulated entity. Management of ITEs is comparatively a new area of interest and there are no guidelines in place for their centralized monitoring in order to get a holistic view of group-wide risks. Unlike the USA where intra-group transactions are collateralized and subjected to limits of 10% and 20% of the bank's capital stock and surplus on individual/ group basis, the current ITEs monitoring arrangement for FCs does not prescribe any restrictions. The Internal Group made certain broad recommendations in regard to the management of ITEs and risk concentrations as below:

- i. parent entity or designated entity² to manage and monitor 'material' intra-group relationships, including transactions and exposures as part of group-wide risk management system;
- ii. regular review and reporting of 'material' ITEs to the respective Boards and also to the parent/ designated entity for facilitating clear understanding of the ITEs undertaken and the risks, if any, emanating there-from;
- iii. compliance with arms' length principle;
- iv. ITEs consistent with safe and sound banking practices. Accordingly, the bank may be prohibited from purchasing a low-quality asset (generally a classified or past-due asset) from a group entity or accepting a low-quality asset as collateral for a loan to any group entity; and
- v. internal prudential limits on exposures to related entities at both individual and aggregate levels including limits on group's exposure to outside counterparties (and their associates), specific geographical locations, industry sectors, specific products, and service providers.

2.6.2.3 Principles for Enhancing Corporate Governance in Banking Organizations

The BCBS in October 2010 issued 'Principles for Enhancing Corporate Governance' for banking organisations. The Principles address fundamental deficiencies in bank corporate governance that became apparent during the financial crisis. Taking into account different categories of banking organisations in India, the Reserve Bank has been taking appropriate steps to improve corporate governance standards in banks. Implementations of 'fit and proper' criteria for directors on the boards of banks and splitting of post of the Chairman and Managing Director in private sectors banks as per the recommendations of the Ganguly Committee (2002) are some of the notable steps taken by the Reserve Bank in this direction in the recent past, which have improved standard of corporate governance. However, a review of the corporate governance standard in the banks is necessitated in the light of the principles issued by the BCBS.

² Designated Entity is usually the parent and/or the most dominant entity in the financial conglomerate and is assigned the responsibility of corresponding with the lead regulator for the purpose of monitoring and supervision of the financial conglomerate.

2.6.2.4 *Regulation of investments of banks in companies engaged in forms of business other than financial services*

Under the extant prudential framework, banks are not required to obtain prior approval of the Reserve Bank for investment in companies other than financial services companies to the extent of 30 per cent of the paid-up capital of investee company or 30 per cent of their own paid-up capital and reserves, whichever is less. Banks may be able to exercise control on such entities through their direct or indirect holdings or have significant influence over them. Thus, banks may indirectly undertake activities not permitted to them under Sub-section (1) of Section 6 of the Banking Regulation Act, 1949 or activities which are not conducive to the spread of banking in India or otherwise useful or necessary in the public interest. Therefore, it is proposed by RBI to stipulate prudential limits to regulate the investments of banks in companies engaged in forms of business other than financial services. Banks will be required to review their investments in such companies and be compliant with the guidelines as per the roadmap to be laid down.

2.7 Financial Stability and Development Council

2.7.1 As part of wall-fencing against any possible financial crisis in the country and with a view to establishing a body to institutionalise and strengthen the mechanism for maintaining financial stability, financial sector development and inter-regulatory coordination, the Government in consultation with the financial sector regulators has set up the Financial Stability and Development Council (FSDC) vide its notification dated December 30, 2010. The Council, chaired by the Union Finance Minister, comprises of Governor, RBI; Finance Secretary and/ or Secretary, Department of Economic Affairs; Secretary, Department of Financial Services; Chief Economic Advisor, Ministry of Finance; Chairman, SEBI; Chairman, IRDA and Chairman, PFRDA. The Council also has a Sub-committee headed by the Governor, RBI that has replaced the existing High Level Coordination Committee on Financial Markets (HLCCFM).

2.7.2 The Council has been entrusted to deal with issues relating to:

- a. Financial stability;
- b. Financial sector development;
- c. Inter-regulatory coordination;
- d. Financial literacy;
- e. Financial inclusion;
- f. Macro prudential supervision of the economy including the functioning of large financial conglomerates;
- g. Coordinating India's international interface with financial sector bodies like the Financial Action Task Force (FATF), Financial Stability Board (FSB) and any such body as may be decided by the Finance Minister from time to time; and
- h. Any other matter relating to the financial sector stability and development referred to by a member/Chairperson and considered prudent by the Council/Chairperson.

2.7.3 The FSDC is expected to improve the effectiveness of the supervision of financial conglomerates by overcoming the following complexities:

- the business structure of the conglomerate may be unrelated to the corporate legal structure, making it difficult for the supervisor to obtain an accurate overview of the business;
- supervisors may have difficulties in understanding the risk management systems in a conglomerate where decisions are made in an unsupervised entity; and
- a financial conglomerate may use informational advantages, cross-subsidies and/or off-market price transactions to undercut competitors in specific financial market segments and to exploit clients (anti-competitive behaviour and conflicts of interest).

2.7.4 Further, as also seen in the sub-prime crisis, inadequately supervised segments of the financial sector such as mortgage brokers are often the source of major problems. FSDC therefore should be looking towards identifying and addressing the regulatory gaps having systemic and financial stability implications.

Chapter 3

Various Models of Conglomeration - Assessment

3.1 Background

3.1.1 Large and Complex Financial Institutions generally referred to as Financial Conglomerates (FCs), have developed primarily over the past few decades, and have become particularly important in recent years. The FCs have come to be accepted as the preferred organizational form of a diversified financial business in many countries. Internationally, the commonly prevalent models straddle the entire spectrum including a holding company model, wherein all bank as well as non-bank financial activities are undertaken through separate subsidiaries of a parent holding company; a bank-subsidiary model which entails banks floating subsidiaries under them to undertake various non-bank financial activities; and a universal banking model wherein all financial activities are undertaken within a single entity.

3.1.2 The international experience indicates that, except in the USA where holding company structure for financial conglomeration is a dominant form, other major jurisdictions do allow multiple forms, including a holding company structure. The specific structures have evolved in response to the nature of conglomeration across financial segments and their regulation. The BHCs and FHCs did not originate in the USA as a considered and preferred choice of financial conglomeration purely from the perspective of better risk diversification or better reaping of the benefits of economies of scale or scope. Rather, their evolution has been intricately linked to the regulatory comfort with banks' affiliation with non-bank activities. For a long time, the debate in the USA has primarily focused on whether or not banks should be permitted to engage in non-banking activities. In the aftermath of the banking crisis in the 1930s, the provisions of the Glass Steagel Act ensured a watertight separation between banks and non-bank affiliates for almost six decades. It was only towards the end of 1990s, when the banks' engagement in non-banking activities had almost come to be accepted as inevitable,

these firewalls were done away with through the GLB Act. This enabled BHCs to enter into non-banking areas, hitherto disallowed, through the FHC route. It appears that for the USA, which had seen the BHC form of banking groups growing for more than a century, allowing BHCs to expand into non-banking activities through HCM, i.e., FHCs was a natural choice. Annex 1 gives a detailed account of the evolution of the BHC/FHC model in the USA.

3.1.3 In the EU, financial conglomerates can be organized through a holding company model and the parent entity can be a regulated entity itself, such as a bank or an insurance company, or a non-financial holding company. Australia permitted the holding company structure as part of liberalization of the range of activities that can be carried out within a conglomerate group containing banks, based on recommendations of the Wallis Commission. In Korea, it was the Asian crisis which triggered the move towards the holding company model in the financial sector.

3.1.4 The recent crisis has however reignited the debate on the nature and scope of the banks' involvement with securities activities. The Volcker rule, which stipulates clear separation between banking and proprietary trading and investments in hedge funds and private equity is at the heart of the legislative reforms in this direction. It is clearly an expression of concerns regarding marrying of traditional banking with investment banking.

3.1.5 As regards the form of conglomeration is concerned, the crisis can be said to be model agnostic. The FHC model in the USA could not ensure isolation of banks from non-bank financial activities – the SPV structure enabled banks to undertake many activities directly. In the EU, on the other hand, where the Bank-Subsidiary model was more prevalent, the inadequacies of consolidated capital requirements at the bank level became evident. The individual banks were found to be under-capitalised both under HCM and BSM, even though the banking groups claimed to have adequate capital at the consolidated level. Though the Basel II framework is applied primarily at the parent/holding company level in a banking group, it also expects the banking supervisors to test that individual banks are adequately capitalized on a standalone

basis and ensure that the capital is readily available for the protection of the depositors and other creditors. There is no defined method of conducting such test. Supervisors used the national discretion, such as definition of materiality, capital deduction split across Tiers I and II etc, to approach this task as considered appropriate in their jurisdiction. As a result, the deduction from a bank's capital of its investments in the subsidiaries/associates was not the uniform practice to test the capital adequacy of a bank on a stand-alone basis, and some jurisdictions were not following such a practice. The recent reforms under the Basel III framework try to plug this loophole and since banks were found to be undercapitalised, it has provided a long phase-in period till 2019 for banks and banking groups to recapitalise themselves. At least from this perspective, HCM is expected to fare better than the BSM because under HCM the subsidiaries and associates/affiliates would be organised directly under the FHC. The other post crisis reform proposals also do not specify preference for any particular model. The focus, as far as structure is concerned, is on:

- Strengthening capital requirements at the consolidated level.
- Reducing complexity of structures to enable efficient resolution of financial institutions.
- Separation of investment banking from commercial banking – the Dodd Frank Act in the US requires proprietary trading and hedge funds/PE investments to be separated from BHCs/FHCs.

3.2 The Bank Subsidiary Model vs. the Holding Company Model

3.2.1 The Working Group focused on assessing the relative pros and cons of the Holding Company Model' (HCM) vis-à-vis the equally prevalent 'Bank Subsidiary Model' (BSM), that is in vogue in India. The universal banking model, it was felt, was not really an option in the Indian context given the entity-focused regulatory approach and historical evolution of financial conglomerates.

3.2.2 The Working Group approached the issue from two fundamental perspectives: first, the risk to bank balance sheets from affiliate non-bank entities and second, the oversight of financial groups from a systemic perspective.

Risk to bank balance sheets

3.2.3 The Group recognised that while the issues of conflict of interest and moral hazard arising from affiliation are there for all financial sector entities, these are most pronounced in case of banks on account of the safety net considerations. The risks from affiliation of banks with non-bank financial activities give rise to the following issues:

Which are the activities that banks can be permitted to undertake directly or indirectly?

3.2.4 Traditionally, the debate regarding the banks' expansion into non-banking activities has centered around the activities such as securities and insurance. International experience and various studies in this regard do not provide unambiguous answers as to whether banks' involvement with non-banking and non-financial areas pose any greater risk to bank depositors compared to standalone banks. However, the recent financial crisis has expanded the scope of this debate to include the impact of off-balance sheet activities of banks on their efficiency and risk. There is ample evidence of banks suffering huge losses during the crisis due to their off-balance sheet activities such as securitization through SIVs, CDO warehousing, proprietary trading, private equity investments and sponsoring of hedge funds.

3.2.5 Presently, the activities that are permitted to be undertaken by a bank in India are statutorily bounded in terms of Section 6 (1) of the Banking Regulation Act. Banks can either undertake these activities departmentally or RBI may require these to be undertaken through a separate subsidiary. The natural implication of this position is that (i) the activities which a bank cannot undertake directly, it can also not undertake through a subsidiary route and (ii) some activities are allowed only through a subsidiary form of organisation. Thus the universe of activities permitted through a subsidiary route is already defined. An incidental issue that has arisen is whether a bank should be permitted through a subsidiary form to undertake activities which can be done departmentally. Clearly this results in regulatory arbitrage particularly for those activities that involve leverage since only banks are required to maintain CRR/SLR.

3.2.6 Given that Indian banks have already expanded into the non-banking areas through their subsidiaries, the consensus was that it would be difficult to contemplate banks' abdication of non-banking financial activities. It was also felt that in view of the dominant role played by banks in the Indian financial system, it was only appropriate that banks lead development of the non-banking sector in the initial phase and their renunciation of these activities could perhaps be examined at a subsequent stage. The Working Group also acknowledged the diversification benefits of combining non-banking activities with the traditional banking. Thus, the more relevant issue for the Working Group was to decide on the extent which banks should be allowed while expanding into non-banking activities. Though there is no evidence that the traditional non-banking activities increase risk for banks, the recent financial crisis has proved beyond doubt that banks' undue involvement in the off-balance sheet activities and sponsoring of SPVs could increase risk for them. Banks will have reputational risks, both under BSM and HCM models.

3.2.7 On balance, the consensus in the Working Group was to allow reasonable expansion for banks into non-banking financial activities with appropriate restrictions on the newer forms of activities such as asset securitization, sponsoring of private equity funds, etc.

Having prescribed the activities, which should be the preferred corporate model for undertaking these activities?

3.2.8 The issue is about the nature of the corporate form through which the permitted activities are undertaken by the bank and the regulatory comfort with various models. Historically, all non-bank activities have been undertaken by banks in India through a subsidiary route – i.e. the bank itself floating separate subsidiaries. Even though the Bank-Subsidiary Model followed in India is also followed internationally in some countries, generally it is believed that such an arrangement unduly concentrates the burden of corporate management of the group and equity infusions in future arising from expansion of business and to meet the regulatory capital requirement in the bank. From

the groups' perspective, such a model also constrains the ability of the shareholders of the parent bank to unlock the value of the parent's holdings in various subsidiaries.

3.2.9 In both BSM and HCM, the parent company directly benefits from profits earned by the subsidiary. However, there is a difference in the nature of the exposure of the banks to the losses from the non-banking activities. Under BSM, the bank reaps the profits and bears the losses (depending on its equity stake and credit extended) associated with these activities. On the other hand, a bank owned by a holding company with non-bank affiliates is not directly exposed to non-bank losses, but at the same time may not benefit from any profits earned by non-bank affiliates.

3.2.10 From a regulatory perspective, one of the key risks posed by the BSM model is that the parent banks is directly exposed to the functioning of various subsidiaries and any losses incurred by the subsidiaries inevitably impact the bank balance sheets. It therefore becomes imperative that the bank regulator has an interest in the health of all subsidiaries under the banks, even as each subsidiary is under the jurisdiction of the respective sectoral regulator. The most obvious risk from affiliation of banks with non-banks is the risk of transference to non-bank affiliates of a subsidy implicit for banks in the safety net, deposit insurance, access to central bank liquidity, access to payment systems, with the attendant moral hazard. This subsidy is more readily transferred to a subsidiary of bank and can, to a certain extent, be reduced through the holding company structure.

3.2.11 It is often argued that prescription of tight firewalls within any given corporate form may suffice to contain transfer of risks between different entities within a conglomerate. However, in practice, given the criticality of reputation risk in the financial services industry, it can be expected that parent entity would be compelled to breach any firewalls if a non-banking affiliate encounter financial difficulties.

3.2.12 The other risk posed by this model is the difficulty in resolution if the bank is in trouble. It came to the fore during the financial crisis that some of the large financial conglomerates were organized in such a complicated way that no one, including the

CEO appreciated the structure or understood it fully. It is therefore important that the organisational structure, whatever it may be, is clean, have clear-cut lines of authority and responsibility, do not produce a complex web of companies and robust enough that cannot be fudged by financial engineering.

Systemic oversight

3.2.13 The financial crisis has also stressed the need for systemic oversight. It has clearly emerged that there was a lack of systemic oversight over the whole financial sector, and in particular, there was lack of adequate regulation and supervision of non-bank financial institutions. The emerging regulatory regime internationally, therefore, entails an explicit agency for systemic oversight including closer monitoring of systemically important financial institutions. In the US, for instance, the Federal Reserve, through the newly constituted Financial Oversight and Stability Council, has been entrusted with enhanced regulation and consolidated supervision of financial as well as non-financial systemically important entities. Similarly, the Bank Holding Companies (BHCs) with assets of \$50 billion or more will be subject to heightened prudential standards, taking into account the heightened risks these entities pose to financial stability.

3.2.14 The FHC model of financial conglomeration seems to fit this new architecture relatively better as compared to the bank-subsidary model. In terms of philosophy and approach to regulation, FHC model makes it cleaner to focus on group-wide risks centrally from a systemic perspective.

3.2.15 The Working Group feels that though the HCM is not conclusively superior to the BSM, it offers some distinct advantages. Specifically,

- HCM model is better in removing capital constraints and facilitating expansion in other financial services. Since under the HCM, the subsidiaries will not be directly held by the bank, the responsibility to infuse capital in the subsidiaries would rest with the holding company.

- The model would also fare better in terms of direct impact of the losses of the subsidiaries, which would be borne by the holding company unlike in the case of BSM where it would be upstreamed to the consolidated balance sheet of the bank.
- Unlike in the case of BSM, under the HCM, the bank's board will not be burdened with the responsibility of managing the group's subsidiaries. Management of individual entities in a disaggregated structure is also expected to be easier and more effective.
- The HCM may enable a better regulatory oversight of financial groups from a systemic perspective. It would also be in consonance with the emerging post-crisis consensus of having an identified systemic regulator responsible *inter alia* for oversight of systemically important financial institutions (SIFI).
- The HCM would provide the requisite differentiation in regulatory approach for the holding company *vis-à-vis* the individual entities.
- The HCM model is likely to allow for neater resolution of different entities as compared with BSM where liquidation of the parent bank may make the liquidation of subsidiaries inevitable.

3.2.16 The Group, therefore, concluded that on balance a holding company model may be more suited in the Indian context. It, however, was conscious of the fact that regardless of the organizational forms, banks cannot be totally insulated from the risks of non-banking activities undertaken by their affiliates.

3.2.17 The Working Group also considered the role of intermediate holding companies in the growth of FCs and the issues arising out of the complexity attributed to insertion of such companies in the FC structure. The Group felt that creation of step down subsidiaries makes it difficult for the investors in the various layers of corporate structures to evaluate the true risk to their investments and ascertain the end use of funds. In any case, the intermediate holding companies may be required only by very large financial conglomerates to organize the related business entities into sub-groups. Since Indian FCs are much smaller than their global peers, intermediate holding companies may not be necessary for them at this stage and it should be possible for them to have only one layer of subsidiaries under the FHC except where there are legal

or regulatory stipulations for example in the case of overseas banking subsidiaries of Indian banks which may be compulsorily required to be the subsidiaries of a bank.

3.2.18 The Group, further, felt that even financial groups without banks could also be of systemic importance particularly if they are large and undertake maturity and liquidity transformation. Therefore, it considered appropriate to define FHC to include even non-banking financial groups so that larger among such financial groups do not escape consolidated supervision by the respective regulators. This would be particularly relevant in case of financial groups having insurance companies which have grown significantly and are monitored under financial conglomerate supervision framework. The insurance companies like banks are mandated by regulators to maintain substantial capital in form of solvency ratio and represents an important domain in the financial sector. It might, therefore, be desirable to keep the new insurance companies as well within the ambit of FHC structure.

3.2.19 *The Working Group, therefore, makes the following recommendations:*

- i) The Financial Holding Company (FHC) model should be pursued as a preferred model for the financial sector in India.*
- ii) The FHC model can be extended to all large financial groups – irrespective of whether they contain a bank or not. Therefore, there can be Banking FHCs controlling a bank and Non-banking FHCs which do not contain a bank in the group.*

Chapter 4

Legal Framework for Financial Holding Companies

4.1 Having decided to recommend the FHC model as a preferred model in the Indian context, the Working Group discussed the following issues relating to legal framework for FHCs in India:

- whether the FHCs can be regulated under Chapter III-B of RBI Act, 1934;
- if not, whether their regulation can be carried out by amending the Banking Regulation Act 1949; and
- whether an entirely different Act like that in many countries including the USA, Korea and Taiwan would be appropriate for regulation of FHCs.

4.1.1 Financial Holding Companies vis-à-vis Reserve Bank of India Act, 1934 (RBI Act)

A company which carries on as its business or a part of its business, the acquisition of shares, stocks etc., would be a non-banking financial company (NBFC) under Section 45I (c) (ii) of RBI Act. Under Section 45IA of the RBI Act, no non-banking financial company shall commence or carry on the business of a non-banking financial institution (which includes the acquisition of shares, stocks etc.) without obtaining a certificate of registration issued by RBI. RBI may issue various directions to NBFCs including with respect to Prudential Norms (Section 45 JA of RBI Act) and relating to the conduct of business (Section 45L of RBI Act). RBI may call for information and returns as also inspect such companies. Further, such NBFCs are required to have a minimum net owned fund as defined in the RBI Act and are required to comply with the requirements of the provisions of Chapter IIIB of RBI Act and Directions, Orders, Circulars and Guidelines issued there under from time to time by RBI.

a) Core Investment Companies

Business of acquisition of shares involves a repetitive activity of buying and selling shares. One-time acquisition of shares for exercising control on the management of a company is distinguishable from such repetitive activity and an entity making such one-time acquisition of shares may not be regarded as carrying on the business of acquisition of shares. As such, companies which are holding shares in their own group of companies for the purpose of holding stake in the companies and not for the purpose of trading in those shares are under certain circumstances, regarded as not carrying on the business of acquisition of shares.

b) Regulation of FHC v. Regulation of NBFC

Even if such companies are brought under the regulatory purview of RBI under Chapter IIIB of the RBI Act, the said regulatory prescriptions will have to be modified to suit the prudential requirements of FHCs. Further, the powers conferred on RBI under Chapter IIIB of the RBI Act to regulate non banking financial companies may not be adequate to comprehensively deal with FHCs in the absence of powers such as the power to change the management of the holding company or give directions as to the kind of other subsidiaries etc. In the circumstances, the applicability of Chapter IIIB of RBI Act to such holding companies may not be regarded as giving adequate regulatory comfort.

In the FHC structure, the FHC will acquire the shares of a banking company and other companies. As such, the business of the FHC will be the business of acquisition of shares in companies. The said business is included in the list of businesses that may be carried on by a financial institution under Section 45I (c) (ii) of RBI Act. In other words, if a company carries on the business of acquisition of shares, such company will become a financial institution for the purpose of RBI Act. FHC being a company under the Companies Act, the FHC will be a nonbanking financial company under Section 45I (f) (i) of RBI Act.

It will be possible for RBI to classify FHCs as a separate category of NBFCs and issue directions appropriate to the risks involved in the conduct of business by FHCs.

However, the power of RBI under Chapter IIIB of RBI Act to regulate NBFCs is not on the same footing as the powers exercised by RBI with respect to banking companies under Banking Regulation Act. For instance, with respect to NBFCs, it is not possible for RBI to remove managerial and other personnel as can be done with respect to banking companies under Sections 36 AA of the Banking Regulation Act. Further, there are no provisions in RBI Act which are similar to the provisions of Sections 10 to 10D of Banking Regulation Act which deal with the management of banking companies. As such, the regulation and supervision of FHCs under chapter IIIB of RBI Act can only be a temporary measure till the enactment of a statute conferring on RBI, the powers for regulating FHCs on the lines of the powers conferred on RBI under the Banking Regulation Act.

4.1.2 Financial Holding Companies vis-à-vis Banking Regulation Act, 1949 (BR Act)

a) Existing Provisions relating to Shareholding in Banks

As regards banking companies, the restrictions on having the holding company and subsidiary company structure are laid down in Sections 12 and 19 of the BR Act.

(i) Section 12 of BR Act

BR Act, at present, does not impose any statutory restriction on the percentage of shares which a person (which expression includes a company) can hold in a banking company. However, under Section 12(2) of the BR Act, regardless of the equity investment, the voting rights on poll shall not exceed 10% of the total voting power of all the shareholders of the banking company. Therefore, unless Section 12(2) is amended, a company, set up to hold more than one-half of the equity shares of a banking company, will not be able to exercise control over the banking company.

(ii) Fit and Proper Criteria

When a banking company reports to RBI, a proposal by any person or persons acting in concert to acquire 5% or more of the paid-up share capital of a banking company, due diligence is carried out to determine whether such person or persons are fit and proper to hold such significant stake in the banking company concerned. The banking company is not permitted to register the transfer of shares if such person or persons are not fit and proper to hold such significant stake in the banking company concerned.

A company becoming a holding company of a banking company by acquiring more than one-half of the nominal value of the equity share capital of a banking company is possible only if RBI grants the permission. If RBI grants permission for such acquisition, it is possible that a company may hold more than one-half of the equity capital of a banking company and thereby become a holding company of a banking company under the Companies Act. Under the Companies Bill, however, acquisition of more than one-half of the equity capital of a company is not sufficient to become a holding company unless it gets more than one-half of the total voting power.

b) Amendments to BR Act Already Proposed

(i) Under the Banking Regulation (Amendment) Bill, 2010, (2010 Bill) introduced in the Parliament, the ceiling on voting rights laid down under Section 12(2) of the BR Act is to be omitted so that all shareholders will be able to exercise voting rights proportionate to their share holding. If the said amendments are carried out, it will pave the way for FHCs to come into existence.

(ii) Since banks accept deposit from the public and play a vital role in the financial system, it is necessary that there are sufficient safeguards to prevent the banking company from being held by a few individuals who are not fit and proper to have significant stake in the management of a banking company. In the 2010 Bill, new Section 12B is proposed to be inserted in BR Act to make it mandatory for any person to obtain previous approval of the Reserve Bank for acquisition of 5% or more of the

paid up capital of a banking company or 5% or more of the voting rights in banking company. The current acknowledgement procedure will get further strengthened and will get statutory backing, if the amendments are carried out.

(iii) The 2010 Bill seeks to introduce a new Section 29A in the BR Act to empower RBI to direct banking companies to furnish to RBI financial statements and/or disclose to RBI, the business/affairs of their associate enterprises. RBI will be empowered to call for such information as it deems necessary for performing its functions under BR Act.

c) Further amendments to BR Act required

(i) If FHCs were to be regulated under the BR Act, the proposed section 12B of BR Act alone would not be sufficient to deal with FHCs. For exercising regulatory powers over FHCs, particularly with respect to registration (license), inspection, giving directions, calling for returns etc., specific powers will have to be conferred by statute. It will then be appropriate to confer such power on RBI and provide for the same in BR Act itself. Some exceptions will have to be carved out in Section 12 of BR Act and an additional chapter will have to be added in the BR Act to achieve the said objective of bringing FHCs under the regulatory jurisdiction of RBI.

(ii) The issues such as, whether a FHC can have more than one bank as a subsidiary, whether any of the subsidiaries of FHC could be a non-banking non financial company and whether there can be multiple layers of holding companies will have to be addressed in the said statutory amendments. Suitable powers to prescribe prudential norms to such FHCs will also have to be incorporated in such legislative provisions. Similarly, the business which such holding company can carry on will also have to be identified.

4.1.3 *Separate Act for Regulating FHCs*

In most countries, a separate Act has been enacted for regulation of FHCs. The Working Group examined the international practices regarding the authority that should be conferred the responsibility of regulating and supervising the FHCs. In the USA, FRB is the regulator of BHCs and FHCs. Non-bank financial conglomerates are not regulated at the group level. In Australia, Bolivia, Canada Cayman Islands, Colombia, Denmark, Ireland, Japan, Korea, Norway, Peru Singapore, Sweden, and United Kingdom a single regulator oversees the activities of all financial conglomerates as a whole. In Argentina, Austria, Estonia, Greece, Hong Kong, Israel, Latvia, Philippines, Spain, Switzerland, and Venezuela identity of the lead regulator for a financial conglomerate is determined on the basis of the financial conglomerate's principal activity. In Bahrain, Belgium, Chile, Czech Republic, Finland, France, Germany, Italy, Luxembourg, Netherlands, Panama, Poland, Portugal, Romania, South Africa, Turkey and Uruguay financial conglomerates operate without a single or lead regulator.

As has been discussed in the previous paragraphs, RBI Act is not considered sufficient to regulate and supervise the FHCs by RBI, mainly for the reason that the legal powers which are required to regulate comprehensively and exercise consolidated supervision on the FHCs are not provided for in the provisions governing NBFCs contained in the RBI Act. In particular, RBI Act do not confer powers to change the management of the holding company or give direction as to the kind of other subsidiaries etc., collect information from and inspect the subsidiaries of the FHCs and the application of bank-like ownership restrictions on the FHCs.

Though the BR Act exclusively deals with the banking companies, it is possible to amend it suitably for the regulation of Banking FHCs. However, as the FHCs in India would also include financial groups not having banks i.e. Non-Banking FHCs, regulating FHCs under BR Act might prove to be unwieldy and messy affair. Besides, the regulation and supervision of FHCs would be different from that of banks and NBFCs as the focus would be more on systemic regulation and consolidated supervision of the

entire group. In the circumstances, it would be preferable to have an entirely new Act for governing FHCs. A new Act will have the following advantages:

- It will avoid any legal uncertainties that could be there if FHCs were to be governed by amending RBI Act or BR Act;
- It will deal with FHCs, both Banking and Non-Banking FHCs exclusively;
- It will align the regulation of FHCs with the objectives of systemic oversight; and
- It will enable design of a regulatory framework for FHCs different in scope and focus from entity regulation.

The Working Group, therefore, recommends that a new law laying down a separate regulatory and supervisory framework for holding companies, overarching the existing functional regulation for various segments, would be the most desirable alternative. An umbrella supervisory authority would be essential to assess how risks to banks may be affected by risks in the other components of a holding company structure and the overarching need of safety and soundness of the system as a whole and the payment system. While firewall provisions can be important safeguards in preventing potential conflicts of interest and protecting insured deposits, in reality the firewalls may not hold up. Such an oversight framework would also ensure that there is no "product arbitrage" across different functional regulatory regimes. However, the Working Group is very clear that the role of the holding company regulator would be supplementary to the existing functional regulators.

4.2 Responsibility for regulation of FHCs under the proposed Act

The Working Group was of the uniform view that given the implicit mandate of the central banks in financial stability and monitoring systemic risks, it would be imperative in the Indian context to vest the responsibility of regulating the financial holding companies with the Reserve Bank. The Reserve Bank would be best suited to design a

separate framework for regulating the financial holding companies, with discernibly different focus from the regulation of banks.

The Working Group therefore recommends that the Reserve Bank should be designated as the regulator for financial holding companies. However, the function of FHC regulation should be undertaken by a separate unit within RBI with staff drawn both from RBI as well as other regulators.

4.3 Conversion to FHC

Financial groups having a bank as the holding company can make transition to the holding company structure with an apex holding company in two ways:

Option I: Demerger of the banking business into a new wholly-owned subsidiary

Under this approach, a new company would be formed and the assets and liabilities of the banking business would be transferred to this new company, which would issue shares to the residual entity. Thus the residual entity would become the holding company.

Option II: Creation of new holding company, swapping of shares with existing shareholders and transfer of non-banking investments by existing banking company to new holding company

Under this approach, a new holding company will be formed and shares of the new holding company will be issued to shareholders of the existing banking company in exchange for shares in the existing banking company, i.e. shares held by the shareholders in the existing banking company will be transferred to the new holding company and the shareholders will be allotted shares of new holding company. Further, shares held by the bank in non-banking subsidiaries will be transferred to such new holding company.

4.4 Special case of Public Sector Banks

4.4.1 In terms of statutory requirements, the Central Government shall, at all times, hold not less than 51% of the issued capital³ consisting of equity shares of the State Bank of India. Similarly, the Central Government shall at all times, hold not less than 51% of the

³ Third proviso of sub-section (2) of Section 5 of State Bank of India Act, 1955.

paid-up capital⁴ of each corresponding new bank as defined in Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970/1980. Further, the whole of the capital of Export Import Bank of India is required⁵ to be held by the Central government. As regards regional rural banks, 50% of the issued capital is required to be held by the Central government, 15%, by the state government concerned and the remaining 35%, by the sponsor bank⁶. The entire share capital of the associate banks⁷ is required to be held by State Bank of India. In view of the said provisions, it will not be possible in the existing set up to have FHCs for SBI and other public sector banks. Therefore, any proposal for re-organizing these banks under the holding company model may require amendments to the aforesaid statutes.

4.4.2 All public sector banks (PSBs) and other institutions, constituted by an Act of Parliament or owned and controlled by the Government are considered public authorities. It would be therefore proper to constitute the FHCs for the PSBs under the Acts governing them. This would ensure that the FHCs set up for the PSBs remain public authorities. Necessary amendments may therefore be made in the respective Acts governing the PSBs for the creation, registration, regulation and supervision of their FHCs by RBI.

4.4.3 The Government may opt to choose one of the two options on transition of PSBs to FHC structure, depending on whether it would like to exercise control over the non-banking subsidiaries of the bank.

Option I: Government holding in PSBs gets transferred to a holding company, which also holds shares in demerged bank subsidiaries.

⁴ Clause (c) of sub-section (2B) of Section 3 of Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970/1980.

⁵ subsection (2) of section 4 of the Export-Import Bank of India Act, 1981.

⁶ subsection (2) of section 6 of the Regional Rural Banks Act, 1976.

⁷ subsection (2) of section 7 of State Bank of India (Subsidiary Banks) Act, 1959

In this case, because of the need for the Government to hold minimum 51 percent in the bank, this option will require the FHC to be listed while the banking subsidiary can remain unlisted. Government would have to continue to support capital requirements of the bank as well as non-bank subsidiaries.

Option II: Government continues to hold directly in the bank while shareholding of all private shareholders gets transferred to holding company. The holding company will also hold shares in the demerged bank subsidiaries.

In this case, the public sector character would not get compromised and existing government powers can continue to be exercised. Further, the Government would be required to support only the capital requirements of the bank.

However, the Option II throws up certain challenges in terms of implementation and administration. The holding company will have as its shareholders, the present private shareholders of banks as well as the joint venture partners of banks in their non-banking subsidiaries and their interests may vary. The holding company will be owned entirely by the present non-government shareholders of the bank. This holding company will have significant shareholdings in PSBs. The bank will have two large shareholders namely, Government of India and the holding company with differing interests. The resulting control/governance issues will need to be addressed. The shareholdings in banks' subsidiaries will be with the existing joint venture partners and the holding company which in turn will be owned entirely by the present non-government shareholders of the bank. Thus, both the holding company and the subsidiaries may have neither Government nor bank representation. The holding company would, effectively, not be a holding company in the sense that it would not be holding controlling stake in the bank. The implications of this arrangement both on the management of the bank and its subsidiaries may have to be looked into in detail. Capital raising for banks can also become complicated and hinder the operations of PSBs. The banks, therefore, need to examine all relevant issues before they opt for this option.

Another issue with Option II could be the mechanism for realisation of value by the Government for its indirect shareholding in bank subsidiaries. This could be addressed if the Government continues to hold, in addition to 51% in the bank, shares in various subsidiaries directly equivalent to its existing indirect holding. Since there is no requirement of minimum holding in these entities there will not be any need for Government to provide capital. This seems to be a workable arrangement.

4.5 Recommendations on Legal Provisions Governing Functioning of FHCs

The Working Group recognises that it may not be possible for the financial groups to make a transition to the HCM unless amendments to the existing Acts governing public sector banks and the amendments to the Income Tax Act/ Stamp duty laws with a view to incentivizing the existing financial groups to reorganize as FHCs are carried out simultaneously. The Working Group makes the following recommendations on legal aspects relating to regulation and supervision of FHCs:

i) Act governing FHCs

The Working Group considers that a separate Act governing the functioning of the FHCs would be most effective legal framework for introducing FHCs in India. Accordingly, a separate new Act for regulation of financial holding companies should be enacted. The amendments should also be simultaneously made to other statutes/Acts governing public sector banks, Companies Act and others, wherever necessary. Alternatively, in order to avoid separate legislation for amending all individual Acts, the provisions of the new Act for FHCs should have the effect of amending all the relevant provisions of individual Acts and have over-riding powers over other Acts in case of any conflict.

ii) Regulatory Authority of FHCs

The Reserve Bank should be designated as the regulator for financial holding companies. However, the function of FHC regulation should be undertaken by a separate unit within RBI with staff drawn from both RBI as well as other regulators.

iii) The new FHC regulatory framework should also formalize a consolidated supervision mechanism through Memorandum of Understanding between regulators.

Chapter 5

Elements of Regulatory and Supervisory Framework for Financial Holding Companies in India

5.1 Objectives of Regulation and Supervision of FHCs

5.1.1 While designing the regulatory and supervisory guidelines for FHCs by the regulatory/supervisory authorities, it is necessary to make a distinction between consolidated supervision of Banking FHCs and Non-Banking FHCs. In particular, care needs to be taken while devising the capital adequacy, liquidity and risk management framework for Non-Banking FHCs to ensure that this does not get extended to all the entities of FHC with the same rigour.

5.1.2 As discussed in the previous chapters, one of the primary objectives of regulating and supervising Banking FHCs is to ensure the safety and soundness of the banks by limiting the risks to them from the non-bank members of the group. Additionally, effective supervision of all types of large and complex FHCs is also an essential part of the systemic risk regulation and supervision. The FHCs will not only own regulated financial intermediaries but may also have controlling interests in other unregulated companies, thereby occupying the most critical place in a holding company structure. Accordingly, it is important to ensure that FHCs operate in a safe and sound manner so that their financial condition does not threaten the viability of regulated financial intermediaries. The monitoring of FHCs is also important because the risks associated with those activities can cut across legal entities and business lines. The three main reasons why FHCs merit special regulation could be regulatory inconsistency, contagion and too-big-to-fail syndrome. Since the regulation and supervision of financial groups having banks differ from those not having banks and also considering the background in which the Working Group was set up, the recommendations are being made mainly in respect of banking groups, and a relatively less rigorous regulatory and supervisory

regime should be created for Non-Banking FHCs by regulators in consultation with each other.

5.2 Scope of Supervisory Guidelines to FHCs

5.2.1 In the US, while supervising the FHCs, the Federal Reserve Board (FRB) relies as much as possible on reports prepared by and for other regulators i.e. from other functional regulators and the affiliates. However, if FRB considers that these reports are insufficient for its needs, then it may directly examine a functionally regulated subsidiary in order to

- assess whether a subsidiary is engaged in an activity that poses a material risk to an affiliated depository institution;
- to be adequately informed about the FHC's systems for monitoring and controlling the financial and operational risks; and
- ensure subsidiary is in compliance with any federal law that the Board has specific jurisdiction to enforce.

The FRB's consolidated supervision of a FHC assesses the '*RFI*' rating based on the following parameters:

R – Risk Management: key assessment - corporate governance functions, Board & senior management, internal audit.

F – Financial Condition: the evaluation and assessments are developed for each 'CAEL' sub-component- Capital Adequacy (C), Asset Quality (A), Earnings (E), and Liquidity (L).

I – Impact:

- assessment of interactions between a FHC's DI (deposit-taking institution) subsidiaries and their non-bank affiliates including the parent company;
- a DI providing funding for non-bank affiliates; and
- risk management and internal control functions being shared between depository and non-bank operations.

5.2.2 The issue of risks in a holding company structure needs to be addressed in a comprehensive way rather than seeing it from the banking perspective only. The present system of consolidated supervision in India under which the banks prepare consolidated financial statements and consolidated prudential returns cannot be regarded sufficient for comprehensive monitoring and addressing the risks in Banking FHCs. It would be necessary to look at the financial position of subsidiaries from the perspective of interconnectedness and aggregate risk profile of the group and their contribution to the systemic risk rather than be concerned with the sole objective of safety of the depositors/investors/creditors' money. It would be therefore imperative to introduce consolidated supervision similar to what is practiced in the USA. This would require conferring additional responsibility and necessary authority to RBI to achieve this objective.

5.2.3 A typical regulatory and supervisory framework for FHCs would cover the following aspects:

- Limits on FHCs involvement in non-banking and non-financial activities;
- Limits on cross-holding between different FHCs and between FHCs and banks outside the group;
- Capital adequacy, permitted leverage and other prudential norms;
- Corporate governance including fit and proper criteria;
- Group-wide oversight functions including audit and review of entities' performance;
- Enterprise-wide risk management;
- Transparency and disclosures norms; and
- Formulation and strict adherence to sound internal policies on:
 - safe and fair conduct of ITEs in compliance with arms length principle,
 - group compliance,

- corporate social responsibility,
- sharing of common brand name,
- resolution of trouble/failed entities in an orderly manner, among others.

5.2.4 A gist of regulations issued by FRB regarding functioning of FHCs is given in Annex-2. The Working Group's recommendations regarding the regulatory and supervisory framework for FHCs in India are set out below.

5.3 Ownership of Banking FHCs

5.3.1 The ownership norms in India are different for the public and private sector banks. While the ownership pattern of public sector banks is governed by the provisions of the respective statutes, that in the case of private sector banks is regulated by the ownership and governance framework put in place by RBI. The migration by a banking group to the FHC structure would result in the bank becoming a subsidiary of the FHC. By definition, an FHC will control a bank. Therefore, keeping with the spirit behind the legal provisions and the ownership and governance framework, it would be necessary to apply the same ownership and governance framework for the banks to their respective FHCs. For instance, in order to remain consistent with the provisions of the Nationalisation Acts, in the case of nationalized banks, it would mean Government of India retaining a stake of 51% in the FHC and foreign investment in the FHC not exceeding 20%. In the case of a FHC controlling a private sector bank, it would mean requiring acknowledgement for acquisition or transfer of shares for any acquisition of shares of 5 per cent and above of the paid up capital of the FHC.

5.3.2 The Working Group appreciates that applying this framework at the level of FHCs would indirectly apply it to non-banking subsidiaries also because under the holding company structure, the level of control operating at the apex level is uniformly applicable indirectly to all the group entities which are controlled by the holding company. As a result, if the ownership restrictions are replicated at holding company

level, it would be difficult for the promoters to have more concentrated holdings in non-banking subsidiaries, if they so desire.

5.3.3 While it would be relatively easier to set up new banks under the holding company structure, there are specific issues concerning migration of existing banking groups from BSM to HCM. Particularly, there are differential norms regarding holding pattern in different category of banks and financial institutions. For example, there is a limit of 74% in private sector banks (FDI and FII under automatic route up to 49% and FIPB route beyond 49% and up to 74%), 20% in public sector banks (under Government's route), 26% in insurance companies (under automatic route) subject to licensing by IRDA, 49% in asset reconstruction companies, 49% in commodity exchanges (FDI-26%, FII-23%) and credit information companies (FII investment not to exceed 24%), 100% in NBFCs under automatic route (NBFCs include variety of businesses such as asset management, merchant banking, broking, venture capital, investment advisory services, factoring, credit card business etc). These divergences primarily reflect regulatory and public policy objectives. Upon migration to a holding company structure by an existing banking group, there might be practical problems in adhering to these differential norms regarding foreign holdings. The solution may lie in harmonising the ownership standards particularly with regard to permissible foreign investment applicable to banks, insurance companies and other financial sector segments at the level of the holding company. Foreign shareholding limits currently applicable to private sector banks would have to be made applicable to FHCs owning private sector banks subsequent to the transition to the FHC model, with the FHC's ownership in the bank permitted up to 100%. In the case of insurance subsidiaries, the existing treatment of foreign shareholding in bank promoters of insurance companies may be extended to the FHC that will own both the bank as well as the insurance company once the FC has transited from the bank-subsidary model to the FHC model.

5.3.4 Under the HCM, since the holding company would control the bank, it would be necessary to ensure that it has the ability to exercise a controlling influence over a

banking organization. One of the major parameters indicating such ability is the financial and managerial strength, integrity, and competence of the holding company. A holding company that controls a bank would reap the benefits of its successful management of the bank but also must be prepared to provide additional financial and managerial resources to the banking organization to support the company's exercise of control. In this way, the potential upside benefits of having a controlling influence over the management and policies of a bank should be tied to responsibility for the potential downside results of exercising that controlling influence. It is expected that by tying control and responsibility together, it would be possible to ensure that holding companies have positive incentives to run a successful bank but also bear the costs of their significant involvement in the bank's decision-making process, thus protecting taxpayers from imprudent risk taking by the holding companies that control banks. It is well known that minority investors in banks held by the holding companies typically seek to limit their potential downside financial exposure in the event of the failure of the banks.

5.4 Limits on FHCs' Involvement in Non-Banking Activities

5.4.1 The rationale behind the existing restriction on banks' equity investment in financial companies is the perception that it is not advisable for banking groups to diversify into non-banking business beyond a limit. It is believed that excessive diversification into non-banking activities may increase the reputational risk for the banks. Even the banking supervisor may not be able to exercise very close supervision on the bank's subsidiaries as these would normally fall under regulatory jurisdiction of other regulators. Though, the consolidated supervision would mitigate this risk to great extent, it cannot be eliminated altogether. Therefore, the best approach to protect banks from non-banking risks is to limit their presence in such areas.

5.4.2 There was a substantial change in the US philosophy concerning banks expansion into non-banking areas in 1990s, which was reflected in passing of GLB Act

paving the way for the present day FHCs which can engage in non-banking activities without any limits. The main reason for such a shift in the approach was the change in perception about the risks posed to the banks by traditional non-banking activities particularly securities and insurance. However, the recent crisis has highlighted the greater risks to banks particularly from newer forms of non-banking activities such as sponsoring of securitization SPVs and private pools of capitals. In the light of these developments, the Group feels that it would be necessary to put in place some limit on the expansion of non-banking business after the existing financial groups dominated by the banks migrate to holding company structure so that growth of banking is not compromised by the banking groups in favour of growth of non-banking business. Presently under the BSM, the banks' total investment in their subsidiaries is capped at 20% of banks' net worth. Under the FHC structure, the allocation of equity capital by Banking FHCs to non-banking subsidiaries should also be capped at a limit as deemed appropriate by RBI to ensure that the banking continue to be a dominant activity of the group.

5.5 Consolidated Supervision of Banking FHCs

5.5.1 Supervision of conglomerates poses peculiar problems as the businesses and the entities carrying on businesses may have different regulators or no regulators. There could be overseas regulators overseeing the operations in their respective jurisdictions. Each sectoral and territorial regulator will have a specific mandate with respect to the territory and the sector, whereas the operations of the conglomerate as a whole could have far reaching impact on the financial system across the jurisdictions.

5.5.2 Each subsidiary company and the holding company being separate legal entity, in theory, the failure of one of the entities should not impact the other companies in the group. However, the management of the companies in the group and their businesses are so interconnected, that it is not possible to insulate one from the losses of the other.

The courts may in exceptional circumstances⁸ lift the corporate veil to see the real persons and entities responsible for the acts or omissions of a company. If a holding company is held responsible for the liabilities of the subsidiary companies, there could be serious repercussions on the group of companies itself. This underscores further, the need for consolidated supervision of banking groups.

5.5.3 The consolidated supervision of FHCs in India would be effected through the concerned sectoral regulator. This arrangement could be formalized through a Memorandum of Understanding (MoU) between the regulators. Normally, for the purpose of consolidated supervision, RBI would rely upon information furnished by the bank and the holding company. However, in certain circumstances, if deemed necessary, RBI may seek relevant information from the subsidiaries/ associate enterprises of a banking company/ holding company or from the sectoral regulators. In rare cases, RBI may cause inspection of a non-banking subsidiary/associate enterprise either jointly or independently in consultation with the concerned sectoral regulator. It is necessary that RBI has sufficient powers under the separate Act for FHCs to collect all relevant material information to assess and address the overall impact of the activities of the conglomerate on the financial system. The Act should provide for signing of MoU between the different regulators to strengthen inter-regulatory coordination by sharing the crucial information and to effectively implement the consolidated supervision as discussed above.

5.5.4 The Working Group felt that it may not be appropriate to subject all FHCs to the same level of regulation and supervision. Differential regulation and supervision of FHCs based on their size, complexity and relative share of banking business would not only conserve supervisory resources, but also avoid unnecessary regulatory and supervisory burden on the non-bank entities within the group.

⁸ *Life Insurance Corporation of India v. Escorts, AIR 1986 SC 1370*, - corporate veil should be lifted where the associated companies are inextricably connected as to be in reality, part of one concern. *State of UP v. Renuagar Power Company, AIR 1988 SC 1737* – lifting of the corporate veil depends primarily on the realities of the situation. For a more detailed analysis, please see, RELATIONSHIP BETWEEN A BANK AND ITS FINANCIAL SUBSIDIARY – SOME LEGAL ISSUES, by S.R.Kolarkar, Joint Legal Adviser, RBI, 1999 Vol 4 RBI Legal News and Views Page 31.

5.6 Consolidated Supervision of Non-Banking FHCs

In Indian financial landscape, it is mostly the large banking groups that can potentially create systemic risks and threaten the market stability. However, there are other financial groups in India, not having a bank in their fold, but considered equally systemically important to large banking groups. The functioning of such identified⁹ non-banking financial conglomerates is presently monitored by the lead regulator through a system of inter-regulatory coordination mechanism. Looking at the role of non-banking financial companies during the financial crisis in the USA, the Working Group feels that the systemically important non-banking financial conglomerates should also be subjected to the enhanced regulation and supervision. There is, therefore, a need for putting in place an appropriate framework for the consolidated supervision of the non-banking financial conglomerates as well so as to bring transparency in their intra-group dealings, assess their impact as a group on the financial system, facilitate their effective regulation. It may be noted that such system should be mandated only for the systemically important non-banking financial conglomerates that would be identified by the regulators in consultation with each other. The regulators may evolve a suitable process for identification of such FCs. The other non-banking financial groups should be kept out of this framework as it would not be justified to subject them to the enhanced regulation and supervision that would not be commensurate with the nature and scale of activities undertaken by them.

5.7 Options with Regard to Listing

5.7.1 The Working Group discussed the relative merits of various options in this regard. If listing is allowed at both the FHC level as well as the subsidiary level, it would give greater flexibility to the groups to raise capital as and when necessary as well as provide greater options to the investors to take selective exposures at entity/group level. At a policy level, in an industry where capital adequacy is a regulatory requirement,

⁹ Few systemically important non-banking financial conglomerates have been identified under the framework developed by RBI, SEBI and IRDA with mutual consultation and are monitored under the financial conglomerate supervision framework.

options available to raise capital should in fact be broader rather than narrower in the long term interest of depositors and lenders.

5.7.2 However, it was also felt that conceptually, in a FHC structure, it is the responsibility of the holding company to raise and deploy capital in subsidiary companies. This role can be undertaken by the holding company more efficiently if it has sole control over capital raising. If listing is allowed at both levels, it may lead to financial and operational inefficiencies.

5.7.3 Another problem with insisting on listing only at the FHC level was that the ownership norms for banks, insurance companies and securities companies differ widely and it may not be possible to dovetail these at the FHC level. Enabling listing at the FHC as well as subsidiary level could address these disparities.

5.7.4 In conclusion, the Working Group decided that given the circumstances prevailing in India, listing can be allowed both at the FHC level as well as the subsidiary level subject to suitable safeguards and governance/ownership norms prescribed by the regulator/s from time to time.

5.8 Recommendations

5.8.1 Ownership Standards

- (i) Intermediate holding companies within the FHC should not be permitted due to their contribution to the opacity and complexity in the organizational structure.*
- (ii) The FHC should be primarily a non-operating entity and should be permitted only limited leverage as stipulated by RBI. However, it could carry out activities which are incidental to its functioning as an FHC.*
- (iii) The FHC should be well diversified and subject to strict ownership and governance norms. The ownership restrictions in Non-Banking FHCs could be applied either at the level of their FHCs or at the entity level, depending upon whether the promoters intend to maintain majority control in the subsidiaries*

wherever it is permissible as per law. In Banking FHCs, the existing ownership controls for banks prescribed by RBI would either be replicated at the FHC level or be retained at the bank level, as considered appropriate by the group and permitted by RBI.

- (iv) The maximum limit for ownership controls in a bank by the FHCs which are not well-diversified will have to be consistent with the threshold fixed for stand-alone banks, with some upward allowance for the fact that the FHCs will also be subject to consolidated supervision. For instance, a closely held FHC may not be allowed to hold more than 30% stake in a private bank, consistent with such limit prescribed by RBI in the case of stand-alone banks.*
- (v) The well diversified FHCs conforming to the prescribed ownership restrictions can hold any level of control in bank.*
- (vi) These ownership and governance standards will also continue to apply at the solo-bank level on the non-FHC shareholders in the bank.*
- (vii) The FHCs should meet the minimum soundness standards in terms of corporate governance, capital and other financial and non-financial parameters as prescribed in the relevant Act as well by RBI.*

5.8.2 Expansion in Non-banking Activities

It would be necessary to put in place some limit on the expansion of non-banking business after the existing financial groups dominated by the banks migrate to holding company structure (Banking FHCs) so that the banking business continues to remain the dominant activity of the group and growth of banking is not compromised by these groups in favour of growth of non-banking business. Presently, under the BSM, the banks' total investment in their subsidiaries is capped at 20% of banks' net worth. Under the FHC structure, the allocation of equity capital by Banking FHCs to non-banking subsidiaries should also be capped at a limit as deemed appropriate by RBI to ensure that the banking continue to be a dominant activity of the group.

5.8.3 Limits on Cross-holding between Different FHCs and between FHCs and Banks outside the Group

RBI should fix appropriate limits on cross-holding between different FHCs. Direct holdings in subsidiaries of a FHC by its promoters or the parent would not be permitted. There should also be cross holding limits between FHCs on the one hand and other FHCs, banks, NBFCs, and other financial institutions outside the group. The cross holding among the entities within the FHC group may be subjected to intra-group transactions and exposure norms to be formulated by RBI.

5.8.4 Capital Adequacy, Leverage and Prudential Norms for Banking FHCs

Capital adequacy norms for Banking FHCs should be as per the prevailing Basel rules for banks. According to existing provisions of Basel II, the capital adequacy in the case of banking groups is required to be applied at the holding company level. Therefore, in the case of Banking FHCs, the capital adequacy would be applicable at the consolidated level. For application of leverage requirements and other prudential norms including exposure norms, similar approach would be followed.

5.8.5 Consolidated Supervision of Banking FHCs

The Act may provide for signing of Memorandum of Understanding between the different regulators to strengthen inter-regulatory coordination by sharing the crucial information including carrying out of inspections by RBI wherever considered absolutely necessary, either jointly or independently in consultation with the concerned sectoral regulator so as to effectively implement the consolidated supervision. RBI, in consultation with other regulators, may evolve a comprehensive framework for consolidated supervision of Banking FHCs on the lines of supervision of FHCs practiced in the US with necessary modifications to suit the Indian requirements. Consolidated supervision, in essence, would be effected through the concerned sectoral regulator. This arrangement could be formalized through a MoU arrangement between the regulators. Major elements of the supervisory framework could be as under:

- (i) Corporate Governance including fit and proper criteria;*
- (ii) Group-wide oversight functions including audit and review of entities' performance;*
- (iii) Enterprise-wide risk management;*
- (iv) Transparency and disclosure norms;*
- (v) Safe and fair conduct of Intra-group Transactions and Exposures (ITEs) in compliance with arms length principle; and*
- (vi) Formulation and strict adherence to sound internal policies on:*
 - o group compliance,*
 - o sharing of common brand name,*
 - o sharing of services, and*
 - o resolution of trouble/failed entities in an orderly manner, among others.*

5.8.6 Consolidated Supervision for Non- Banking FHCs

Respective regulators, in consultation with each other, may put in place an appropriate framework for consolidated supervision of Non- Banking FHCs with total assets above a threshold considered appropriate.

5.8.7 Listing of FHCs

It is possible to envisage in a holding company structure to have either a listed holding company with all subsidiaries being unlisted or both the holding company with all or some of its subsidiaries being listed depending on the objectives and strategy of the financial group and the prevailing laws and regulations on investment limits. Given the circumstances prevailing in India, listing can be allowed both at the FHC level as well as the subsidiary level subject to suitable safeguards and governance/ownership norms prescribed by the regulator/s from time to time.

5.8.8 Preparation of Consolidated Accounts

Presently, the consolidation of accounts is mandatory only under the listing agreement. However, an FHC may not be necessarily a listed company. The regulatory authority of FHCs should, therefore, require them to prepare consolidated accounts and place in public domain.

Chapter 6

Operationalisation of the Framework and Transition Issues

6.1 The Working Group has recommended enactment of a separate Act for regulating financial holding companies. However, the Working Group recognises the challenges in the process of enactment of a new Act and is cognizant of the fact that it will be a while before this can be achieved, presuming the recommendations are accepted by all stakeholders.

6.2 Further, there are complex legacy and policy issues concerning various financial sectors viz. banking, insurance, securities activities etc. which may constrain a clean transition to the FHC model at a systemic level. These mainly relate to the differential Government ownership in various categories of banks and other sectors, differential ownership and governance standards prescribed by various regulators and differential ceilings for foreign ownership prescribed for various sectors. These divergences primarily reflect regulatory and public policy objectives. Bringing all financial activities of a group within a single FHC would presuppose harmonisation among different sector policies.

6.3 The Working Group also recognises that it may not be possible for the existing financial groups to make a transition to the FHC model unless suitable amendments to various Acts are made to make the transition from existing BSM model to FHC model tax and stamp duty neutral.

6.4 The Group, therefore, concluded that the FHC model may have to be phased in gradually over a period taking into account the specific challenges. Such a calibrated approach, it was recognised, will need to give a greater leeway to the existing groups for adoption of the FHC model as compared to new ventures in banking or insurance. Any new regulatory framework can be applied prospectively for new entities and in

regard to existing entities it has to be a calibrated approach. Accordingly, the Group recommends the following operational scheme:

6.4.1 Regulatory Framework

Pending enactment of a separate Act, the FHC model may be operationalised under the provisions contained in the RBI Act. The FHC, accordingly, will be registered as an NBFC with the RBI and the RBI will frame a suitable regulatory framework, as detailed in Chapter 5, for FHCs in consultation with other regulators.

6.4.2 New Banks and Insurance Companies

All new banks and insurance companies, as and when licensed, will mandatorily need to operate under the FHC framework. For new banks, the Group recommends that:

- (i). The promoter/s would be required to float a new holding company which would initially be 100% owned by the promoter/s and have the new banks as its wholly owned subsidiary.
- (ii). All the ownership norms, as prescribed in the licensing conditions, would be made applicable either at the FHC level or at the bank level.
- (iii). In case the promoter entity/ies already have a non-bank financial subsidiary, such subsidiaries would be brought under the holding company in a phased manner.

6.4.3 Existing Groups

- (i). All identified financial conglomerates having a bank within the group will need to convert to the FHC model in a time bound manner, once the pre-requisites necessary to make the transition tax neutral are in place.

- (ii). In cases the above conglomerates do not want to convert to FHCs, they should be required to confine only to those activities which the banks are presently permitted by RBI to undertake departmentally. This would mean that such conglomerates should eventually divest their holding in the subsidiaries.
- (iii). For all other banking groups, conversion to the FHC model may be optional till the enactment of the FHC Act.
- (iv). All non-banking financial conglomerates may have the option to convert to the FHC model. Those having insurance companies and do not adopt the FHC model should comply with the extant regulations regarding promoters stipulated by IRDA.

6.5 Taxation Issues

In order to make the migration to an approved FHC structure viable; the same would need to be tax neutral. Accordingly, the following one-time tax waivers are proposed for entities undergoing restructuring consequent to migration to an approved FHC structure.

6.5.1 *Taxation of a transfer consequent to the migration to an approved FHC structure*

The migration to an approved FHC structure could be achieved by one or a combination of the following:

Option 1: Demerger

- The FHC would demerge its operational undertaking to a Member, under a scheme of demerger sanctioned by the Court under the provisions of sections 391-394 of the Companies Act, 1956 (Companies Act). Under the scheme all the shares of the Member would be allotted to the FHC.
- It is recommended that the Income Tax Act, 1961 (ITA) be amended to provide that the transfer, by way of demerger of its operational undertaking, from a FHC

to a Member under a scheme of demerger for the purposes of migrating to an approved FHC structure should not be regarded as a transfer and there ought to be no liability to tax in the hands of FHC

Slump Sale:

- The FHC would transfer its operational undertakings (comprising the assets and liabilities) to a Member under a slump sale.
- It is recommended that the ITA be amended to provide that the transfer of a capital asset of one or more undertakings owned and held by the FHC to a Member under a slump sale for the purposes of migrating to an approved FHC structure should not be regarded as a transfer and there ought to be no liability to tax in the hands of the shareholders of the Member.
- It is recommended that the ITA be amended to provide that the transfer of a capital asset (whether long-term or short-term) from a FHC to a Member for the purposes of migrating to an approved FHC structure should not be regarded as a transfer and there ought to be no liability to tax in the hands of the FHC and that the condition of continued holding be made inapplicable.

Option 2: Share Swap

- There could be some cases where the FHC does not hold the entire share capital of the Member. In such cases, in order to make the Member a 100% subsidiary of the FHC under the FHC structure; the FHC would have to acquire the shares of the Member from its existing shareholders. In consideration for such transfer, the FHC may issue its shares to the shareholders of the Member (share swap).
- It is recommended that the ITA be amended to provide that the receipt of shares of a FHC in exchange of shares of a Member consequent to the migration to an approved FHC structure should not be regarded as a transfer and there ought to be no liability to tax in the hands of the shareholders of the Member. If shares of a FHC are allotted in exchange of shares of a Member which becomes its subsidiary, cost and date of acquisition of shares of the Member be adopted as cost and date of acquisition of shares of the FHC for the shareholders.

It should be provided that any income arising to the shareholders of the Member consequent to the migration to an approved FHC structure should be exempt from tax. To summarize, the ITA may be suitably amended to provide for a one-time exemption to the originating entity, shareholders and new entity for gains, if any, arising from transfers during the restructuring of financial companies while migrating to an approved FHC structure in any manner and form, whether it be:– (i) a transfer of shares of the Member in the hands of the shareholders of the FHC/ Members; or (ii) a transfer of business undertaking (banking business) by the FHC to Members and vice-versa; or (iii) any payments/ distributions to the shareholders of the FHC/ Members.

A one-time option should be given to FHC to either claim the tax benefits by way of unabsorbed depreciation, carry forward losses and MAT credit in its own hands or transfer the tax breaks to the new entity.

6.5.2 *Carry forward of losses, unabsorbed depreciation, Minimum Alternate Tax (MAT) credit, etc.*

- A one-time option should be allowed to FHC to either claim the tax benefits by way of unabsorbed carry forward losses and unabsorbed depreciation in its own hands or transfer the tax breaks to the new entity.
- A one-time option should be allowed to FHC to allow the MAT credit of the Members prior to migration to an approved FHC structure be available for set-off by the FHC/ new entity in future years.
- Further, in the case of migration to an approved FHC structure; the losses of the Members should continue to be available to the FHC/new entity.

6.6 *Issues relating to Reserves and Dividend Distribution Tax*

6.6.1 *Creation of a reserve fund prior to declaring dividend*

The financial sector entities, like banks, NBFCs etc., are required to transfer a certain percentage of profit to a reserve prior to the declaration of dividend. At the level of the

holding company also, certain percentage of profits have to be transferred to reserves prior to declaration of dividends. It is argued that this could lead to the 'trapping of capital' within the subsidiaries. In order to have an efficient holding company structure, it may be ensured that post-FHC, dividend distribution tax regime does not apply to upstreaming of dividends to the FHC level purely for the purpose of investment in other affiliates. This dispensation is justified in the case of financial entities in view of the minimum capital and capital adequacy regulations. Such a change would also need amendments to extant sectoral regulations and other relevant laws and regulations.

6.6.2 Dividend Distribution Tax

It is recommended that a Member should not be liable to pay Dividend Distribution Tax (DDT) on amounts distributed to the FHC to the extent the dividend distribution is utilized for making equity investment in subsidiaries of FHC.

6.7 Introduction of the Direct Taxes Code, 2010

The Government of India has tabled the Direct Taxes Code Bill, 2010 (DTC) before the Parliament. The provisions contained in the DTC, once passed by Parliament, will come into force from April 1, 2012. Some of the provisions of the DTC might be required to be amended in light of the above proposals.

Indirect taxes

Necessary amendments may be made in respective states VAT laws and proposed GST to exempt transfer of moveable assets in migration to FHC structure from tax.

6.8 Incidence of Stamp duty

It is recommended that a stamp duty exemption be made available on all aspects of migration to an approved FHC structure.

Evolution of BHCs and FHCs in the USA

1. The case of the USA presents a very relevant example of evolution of bank holding companies and financial holding companies in the world. The regulations governing operations of FHCs in different parts of the world largely reflect the experience gained by the USA in regulating and supervising the FHCs. The chartering of the First Bank and Second Bank were significant events in the history of the US Banking System. The First Bank was chartered by the United States Congress in 1791 for 20 years. The Bank was created to handle the financial needs and requirements of the central government of the newly formed United States, which had previously been thirteen individual States with their own banks, currencies, financial institutions, and policies. The Second Bank of the United States was chartered in 1816, five years after the First Bank of the United States lost its own charter. The US entered a period of “Free Banking” after the expiry of the charter for the Second Bank in 1836. Banks were chartered by the States and regulated by the State banking authorities.

2. National Banking Acts of 1863 and 1864 enabled establishment of national banks to be regulated by the Office of the Controller of Currency (OCC). The mandate for these banks was to issue bank notes and, therefore, the regulation was also focused on ensuring their ability to redeem the bank notes. The normal banks chartered by the individual States continued to function concurrently. After the creation of Federal Reserve Board (FRB) in 1914, the two issues reappeared: (i) branching which was hitherto prohibited for the national banks and (ii) permissible activities of national banks. Both FRB and OCC favoured permitting banks to branch out and buy and sell investment securities but not stocks.

3. With passage of the McFadden Act of 1927, national banks were allowed to both to branch out and trade in investment securities. Though national banks were not permitted to set up affiliates for undertaking the activities prohibited for national banks, they were allowed to organise under BHC structure under which these activities could

be carried out. This provided a fillip to growth of BHCs in the USA. Two factors contributed to growth of BHCs in 1920s. The Clayton Act, 1914 prohibited acquisition of one corporation by another as it was deemed to promote monopolies. Secondly, the State governments had limited powers to control BHCs. The growth of BHCs was also stimulated by need for rural bank reforms, the consolidation movement in the banking industry and the boom in the stock market which stimulated demand for holding company shares.

4. Due to a significant growth in the number of BHCs and their assets, in 1930, legislation was introduced to specifically regulate BHCs. Major features of the legislation were: (i) recognition of the need for treating the BHCs as an integrated entity, not as separate enterprises, and (ii) in order to get a proper picture of the financial condition of the bank it was considered necessary to have complete disclosure of information on all affiliates of the BHCs and thus the consolidated balance sheet of the BHCs would be the relevant information. By 1929, the BHC structure represented one fourth of banks and one half of loans and investments. Another important event during the period was inquiry into the bank affiliates system which was alleged to have been abused, mainly through frauds, dealing by affiliates in the stock of the parent bank, shifting of poor bank assets to affiliates to hide the mistakes of banks and reputational risk of affiliates for the parent. This resulted in the demand for separation of commercial and investment banking and culminated in passing of Banking Act of 1933 severely restricting the non-banking activities of BHCs.

5. However, there was still a feeling that the Banking Act of 1933 was not effective in restricting the expansion of BHCs in the non-banking areas. In particular, there were apprehensions of financial concentration resulting from a few multistate bank holding companies acquiring control over a large percentage of nationwide banking assets. In addition, concentration also could result from the affiliation of major nonfinancial corporations with leading banking organizations. It was feared that huge banking and industrial conglomerates of this type would dominate the economic system. Besides, some believed that a BHC should not be permitted to perform activities that could not be

performed directly by a bank. By this line of reasoning, if the activity was not safe or appropriate for a bank, then it was not safe or proper for an organization owning a bank. Further, many non-bank businesses expressed apprehensions that firms affiliated with banks would gain a competitive advantage over unaffiliated competitors in the same industry. These businesses were concerned that firms affiliated with banks would receive preferential credit treatment from the banks and would have access to low-cost funds provided to them from non-interest-bearing deposits. Also, there was a persistent apprehension that a bank would tie access to credit to the purchase of services provided by its non-bank affiliates.

6. Due to the above concerns, under the Bank Holding Company Act of 1956, non-bank activities were very severely restricted and permitted mainly those activities incidental to banking or performing services for banks. Approved activities included ownership of the bank's premises, auditing and appraisal, and safe deposit services. BHC Act of 1956 amended some provisions of the Banking Act 1933 and conferred powers on FRB to regulate BHCs, which were hitherto regulated by OCC. These amendments also had the impact of severely restricting the non-banking activities of multi-bank BHCs. Consequent upon the BHC Act of 1956, the banking, insurance and securities and other financial services grew and developed in silos. By the end of 1970, there were 111 multi-bank holding companies controlling 16.2% of commercial bank deposits. Only a few of the smaller multi-bank holding companies operating before the passage of the 1956 legislation divested banks after the law was enacted so as to become one-bank holding companies and avoid regulation. In due course, the one-bank holding companies, though not yet regulated, began to be perceived as a potential source of many of the same difficulties that their opponents associated with multi-bank holding companies. This prompted amendment of BHC Act in 1970 extending the FRB regulation to single bank BHCs also.

7. The 1990s saw an intensification of debate in the USA regarding the effects of permitting US commercial banks to expand their range of activities into non-banking areas particularly securities and insurance. Proponents of expanded powers argued that

there were potential benefits for banks including gains in efficiency from the realisation of economies of scope, risk reduction through greater diversification, and expanded opportunities to compete for commercial and retail customers as technology and preferences evolve. Further, if barriers to entry are removed, greater competition in financial markets will result in more options, lower prices, and greater convenience for customers of bank and non-bank financial companies. In 1999, this debate resulted in repeal of some of the provisions of Glass Steagall Act and BHC Act 1956 through passage of Gramm-Leach-Bliley (GLB) Act which allowed BHCs to expand into non-banking areas through affiliates and thus became FHCs. Many BHCs have converted themselves into FHCs after passage of this Act.

The Bank Subsidiary Model vs. the Holding Company Model

8. In the USA, the debate about the choice of an appropriate conglomeration model picked up during the 1990s when it was considered appropriate to allow banks to expand into non-banking areas *albeit* with safeguards. A number of factors seem to have been considered in making judgments about which structural model was most appropriate for the U.S. banking system in an environment of expanded powers. The first factor was the impact of alternative structures on regulators' ability to assess, monitor and control the riskiness of insured deposit taking institutions in large financial conglomerates. This determination hinged on one's view of the nature of the risks inherent in specific non-banking activities, and whether or not it was possible to insulate insured deposit taking institutions from these risks. The impact of proposed structures on efficiency was also considered. Ideally, regulated entities should be able to operate with a degree of efficiency approximating that of suppliers of substitutes. Another issue considered was whether the proposed change placed U.S. banking organizations at a significant competitive disadvantage relative to foreign competitors either at home or abroad. In addition, care was taken that small U.S. banks were not disadvantaged relative to large U.S. banks. The compatibility of any proposed structure with the present system of laws and regulations applicable to banks was also a relevant factor

(e.g. bankruptcy law, "corporate separateness", etc.). Making new laws and substantial changes in regulations takes considerable time. Thus, altering the existing system was considered to be preferable to starting from scratch. The need for changes in the then prevailing regulatory framework was also considered (i.e. the role of the States and the Federal Reserve, etc.).

9. The U.S. approach reflects the view that the HCM, with Section 23A and 23B firewalls is superior to the BSM. Proponents of the HCM cite the advantage of needed greater insulation at roughly the same or slightly higher cost, than that of the bank subsidiary model. The HCM also has the advantage of being the structure already in place in the United States. The model had a track record; supervisors and bankers were familiar with it. It was generally acknowledged that there was less domestic experience with the bank subsidiary model in the USA when the GLB Act was enacted.

Recent US Financial Regulatory Reforms

10. In the USA, the Dodd-Frank Wall Street and Consumer Protection Act has introduced significant reforms in the regulation and supervision of financial holding companies. The key relevant provisions of the Act are as under:

- Establishes a new Financial Stability Oversight Council (FSOC) to monitor systemic risk;
- Allows the Council to designate nonbank financial firms as systemically important and subject them to Federal Reserve supervision;
- Requires the Federal Reserve to develop enhanced prudential standards for all BHCs with \$ 50 billion or more assets, as well as systemically important nonbank financial firms;
- Allows orderly resolution of failing, systemically-significant BHCs or non-bank financial firms by FIDC;
- Makes a number of changes to the regulatory and supervisory framework for banking organizations, such as "Volcker Rule" activity restrictions and concentration limits, "Lincoln Amendments" derivative push outs, "Collins

Amendment” subjecting BHCs and systemic nonbank financial firms to risk-based and leverage capital requirements;

- Establishes a new, optional framework for resolution of non-bank financial companies, defined to include BHCs, securities broker-dealers or any other U.S. company that derives at least 85% of its annual revenues from financial activities (including revenue from any deposit taking subsidiaries);
- The existing regulatory framework for BHCs/FHCs in the USA is bank-centric, in the sense that the objective of regulation of BHCs/FHCs is to ensure that the bank is not unduly exposed to the risks arising from activities of non-banking subsidiaries of the BHC/FHC. The non-banking entities which may not be part of BHCs/FHCs also did not attract much supervisory attention in the USA. However, the recent crisis has underscored the systemic importance of many large non-banking entities particularly of those which in some way or the other had inter-linkages with banks. The new law therefore authorizes the Federal Reserve to examine the activities of non-bank subsidiaries of a BHC (other than a functionally regulated subsidiary) like that of a deposit taking institution;
- Prohibits insured deposit taking institutions and their affiliates from engaging in “proprietary trading” and investing in, sponsoring or having certain business relationship with hedge fund or private equity fund; and
- Subjects BHCs and systemic nonbank financial firms to risk based capital and leverage requirements that are at least as strict as the risk-based and leverage capital requirement that apply to banks. This has been considered necessary in view of the systemic importance of large BHCs and other non-banking entities in USA.

11. The financial crisis has also shown that there was a lack of systemic oversight over the whole financial sector, in particular, there was lack of adequate regulation and supervision of non-bank financial institutions, and their capacity to create systemic crisis. The FSOC’s duties, therefore, include determining which, if any, non-bank financial companies are systemically significant and will be subject to enhanced and consolidated supervision by the Federal Reserve. Similarly, the Bank Holding Companies (BHCs) with assets of \$50 billion or more will be subject to heightened prudential standards, taking into account the heightened risks these entities pose to

financial stability. The heightened prudential standards will include risk-based capital and leverage requirements, liquidity requirements, concentration limits, stress test requirements and resolution plan.

Approach to Regulation of FHCs in the USA

S. No	Various Aspects of Regulatory Framework for FCs	Provisions as applicable in the USA
1.	Regulator of BHCs/FHCs	<ul style="list-style-type: none"> • In the USA, FRB is the regulator of BHCs and FHCs. Non-bank financial conglomerates are not regulated at the group level. • In Australia, Bolivia, Canada Cayman Islands, Colombia, Denmark, Ireland, Japan, Korea, Norway, Peru Singapore, Sweden, and United Kingdom a single regulator oversees the activities of all financial conglomerates as a whole • In Argentina, Austria, Estonia, Greece, Hong Kong, Israel, Latvia, Philippines, Spain, Switzerland, and Venezuela identity of the lead regulator for a financial conglomerate is determined on the basis of the financial conglomerate's principal activity • In Bahrain, Belgium, Chile, Czech Republic, Finland, France, Germany, Italy, Luxembourg, Netherlands, Panama, Poland, Portugal, Romania, South Africa, Turkey and Uruguay financial conglomerates operate without a single or lead regulator
2.	Definition of FHC	<p>An FHC is a BHC which meets the following requirements:</p> <ol style="list-style-type: none"> (1) All depository institutions controlled by the bank holding company must be and remain well capitalized; (2) All depository institutions controlled by the bank holding company must be and remain well managed; and (3) The bank holding company must have made an effective election to become a financial holding company. <p><i>Bank holding company</i> means any company (including a bank) that has direct or indirect control of a bank. <i>Control</i> of a bank or other company means</p> <ol style="list-style-type: none"> (i) Ownership, control, or power to vote 25% or more of the outstanding shares of any class of voting securities of the bank or other company, directly or indirectly or acting through one or more other persons; (ii) Control in any manner over the election of a majority of the

		<p>directors, trustees, or general partners (or individuals exercising similar functions) of the bank or other company;</p> <p>(iii) The power to exercise, directly or indirectly, a controlling influence over the management or policies of the bank or other company; or</p> <p>(iv) Conditioning in any manner the transfer of 25% or more of the outstanding shares of any class of voting securities of a bank or other company upon the transfer of 25% or more of the outstanding shares of any class of voting securities of another bank or other company.</p>
3.	Ownership of FHCs and banks held by FHCs	Not available
4.	Permissible activities for FHCs	<p>In the USA, an FHC may engage in any activity, and may acquire and retain the shares of any company engaged in any activity, that the Federal Reserve Board, determines (by regulation or order)</p> <ul style="list-style-type: none"> • to be financial in nature or incidental to such financial activity; or • is complementary to a financial activity and does not pose a substantial risk to the safety or soundness of depository institutions or the financial system generally
5.	Limit on investments in non-financial companies	Limited to 5% of the investee company's equity.
6.	Limit on cross-holding between BHCs/FHCs and other BHCs/FHCs/ other banks/FIs/ NBFCs which are not part of the BHC/ FHC in question	<ul style="list-style-type: none"> • Prohibition of direct or indirect acquisition of over 5% of any additional bank's or bank holding company's shares without prior Board approval. • Prohibition on existing bank holding company from increasing, without prior Board approval, its ownership in an existing subsidiary bank unless greater than 50% of the shares are already owned

7.	Activities that are considered as financial in nature	<p>In the USA, for FHCs, the following activities are considered to be financial in nature:</p> <p>(A) Lending, exchanging, transferring, investing for others, or safeguarding money or securities.</p> <p>(B) Insuring, guaranteeing, or indemnifying against loss, harm, damage, illness, disability, or death, or providing and issuing annuities, and acting as principal, agent, or broker for purposes of the foregoing, in any State.</p> <p>(C) Providing financial, investment, or economic advisory services, including advising an investment company.</p> <p>(D) Issuing or selling instruments representing interests in pools of assets permissible for a bank to hold directly.</p> <p>(E) Underwriting, dealing in, or making a market in securities.</p> <p>(F) Engaging in any activity that the Board has determined, by order or regulation that is in effect on the date of the enactment of the Gramm-Leach-Bliley Act, to be so closely related to banking or managing or controlling banks as to be a proper incident thereto (subject to the same terms and conditions contained in such order or regulation, unless modified by the Board).</p> <p>(G) Engaging, in the United States, in any activity that--</p> <p>(i) a bank holding company may engage in outside of the United States; and</p> <p>(ii) the Board has determined to be usual in connection with the transaction of banking or other financial operations abroad.</p> <p>(H) Directly, or indirectly acquiring or controlling, whether as principal, on behalf of 1 or more entities (including entities, other than a depository institution or subsidiary of a depository institution, that the bank holding company controls), or otherwise, shares, assets, or ownership interests (include debt or equity securities, partnership interests, trust certificates, or other instruments representing ownership) of a company or other entity, whether or not constituting control of such company or entity, engaged in any activity not authorized pursuant to this section if--</p> <p>(i) the shares, assets, or ownership interests are not acquired or held by a depository institution or subsidiary of a depository institution;</p> <p>(ii) such shares, assets, or ownership interests are acquired and held by--</p> <p>(I) a securities affiliate or an affiliate thereof; or</p> <p>(II) an affiliate of an insurance company described in subparagraph (I)(ii) that provides investment advice to an insurance company and is registered pursuant to the Investment Advisers Act of 1940, or an affiliate of such investment adviser;</p>
----	--	---

		<p>as part of a bona fide underwriting or merchant or investment banking activity, including investment activities engaged in for the purpose of appreciation and ultimate resale or disposition of the investment;</p> <p>(iii) such shares, assets, or ownership interests are held for a period of time to enable the sale or disposition thereof on a reasonable basis consistent with the financial viability of the activities described in clause (ii); and</p> <p>(iv) during the period such shares, assets, or ownership interests are held, the bank holding company does not routinely manage or operate such company or entity except as may be necessary or required to obtain a reasonable return on investment upon resale or disposition.</p> <p>(I) Directly or indirectly acquiring or controlling, whether as principal, on behalf of 1 or more entities (including entities, other than a depository institution or subsidiary of a depository institution, that the bank holding company controls) or otherwise, shares, assets, or ownership interests (including debt or equity securities, partnership interests, trust certificates or other instruments representing ownership) of a company or other entity, whether or not constituting control of such company or entity, engaged in any activity not authorized pursuant to this section if--</p> <ul style="list-style-type: none"> • the shares, assets, or ownership interests are not acquired or held by a depository institution or a subsidiary of a depository institution; • such shares, assets, or ownership interests are acquired and held by an insurance company that is predominantly engaged in underwriting life, accident and health, or property and casualty insurance (other than credit-related insurance) or providing and issuing annuities; • such shares, assets, or ownership interests represent an investment made in the ordinary course of business of such insurance company in accordance with relevant State law governing such investments; and • during the period such shares, assets, or ownership interests are held, the bank holding company does not routinely manage or operate such company except as may be necessary or required to obtain a reasonable return on investment.
8.	Registration of FHCs	BHCs required to register with the Fed Reserve on prescribed forms including information with respect to the financial condition

		and operations, management, and intercompany relationships of the bank holding company and its subsidiaries, and related matters
9.	Supervision of FHCs	<p>1. An FHC and its subsidiaries may be required to submit reports under oath with regard to --</p> <ul style="list-style-type: none"> (i) its financial condition, systems for monitoring and controlling financial and operating risks, and transactions with depository institution subsidiaries of the bank holding company; and (ii) compliance by the company or subsidiary with applicable provisions of this Act or any other Federal Law that the Board has specific jurisdiction to enforce against such company or subsidiary. <ul style="list-style-type: none"> • any report considered necessary to assess a material risk to BHC or any of its depository institution subsidiaries or compliance with the BHC Act or any other Federal law that the Board has specific jurisdiction to enforce against such company or subsidiary or the systems, the Board may require such functionally regulated subsidiary to provide such a report to the Board. <p>2. Board may make examinations of each bank holding company and each subsidiary of such holding company in order--</p> <ul style="list-style-type: none"> (i) to inform the Board of the nature of the operations and financial condition of the holding company and such subsidiaries; (ii) to inform the Board of— <ul style="list-style-type: none"> • the financial and operational risks within the holding company system that may pose a threat to the safety and soundness of any depository institution subsidiary of such holding company; and • the systems for monitoring and controlling such risks; and • to monitor compliance with the provisions of this Act or any other Federal law that the Board has specific jurisdiction to enforce against such company or subsidiary and those governing transactions and relationships between any depository institution subsidiary and its affiliates. <p>3. The Board may also make examinations of a functionally regulated subsidiary of a BHC only if--</p> <ul style="list-style-type: none"> (a) the Board has reasonable cause to believe that such

		<p>subsidiary is engaged in activities that pose a material risk to an affiliated depository institution;</p> <p>(b) the Board reasonably determines, after reviewing relevant reports, that examination of the subsidiary is necessary to adequately inform the Board of the systems described or</p> <p>(c) based on reports and other available information, the Board has reasonable cause to believe that a subsidiary is not in compliance with this Act or any other Federal law that the Board has specific jurisdiction to enforce against such subsidiary, including provisions relating to transactions with an affiliated depository institution, and the Board cannot make such determination through examination of the affiliated depository institution or the bank holding company.</p> <p>4. The Board shall, to the fullest extent possible, limit the focus and scope of any examination of a bank holding company to--</p> <p>(i) the bank holding company; and</p> <p>(ii) any subsidiary of the bank holding company that could have a materially adverse effect on the safety and soundness of any depository institution subsidiary of the holding company due to--</p> <ul style="list-style-type: none"> • the size, condition, or activities of the subsidiary; or • the nature or size of transactions between the subsidiary and any depository institution that is also a subsidiary of the bank holding company.
10.	Provisions applicable to financial holding companies that fail to meet certain requirements	<p>The Federal Reserve Board may require such financial holding company, either—</p> <p>(A) to divest control of any subsidiary depository institution; or</p> <p>(B) to cease to engage in any activity conducted by such financial holding company or its subsidiaries (other than a depository institution or a subsidiary of a depository institution) that is not an activity that is permissible for a bank holding company.</p>
11.	Limitation on direct action by the Regulator of FHCs	<p>The Board may not prescribe regulations, issue or seek entry of orders, impose restraints, restrictions, guidelines, requirements, safeguards, or standards, or otherwise take any action under or pursuant to any provision of this Act or section 8 of the Federal Deposit Insurance Act against or with respect to a functionally regulated subsidiary of a bank holding company unless--</p> <p>(i) the action is necessary to prevent or redress an unsafe or unsound practice or breach of fiduciary duty by such subsidiary that poses a material risk to--</p> <p>(A) the financial safety, soundness, or stability of an affiliated</p>

		<p>depository institution; or</p> <p>(B) the domestic or international payment system; and</p> <p>(ii) the Board finds that it is not reasonably possible to protect effectively against the material risk at issue through action directed at or against the affiliated depository institution or against depository institutions generally.</p> <p>The Federal Reserve has supervisory oversight authority and responsibility for BHCs that operate as FHCs and for BHCs that are not FHCs. The GLB Act sets parameters for operating relationships between the Federal Reserve and other regulators. The statute differentiates between the Federal Reserve's relations with (1) depository institution regulators and (2) functional regulators, which include insurance, securities, and commodities regulators. The Federal Reserve's relationships with functional regulators will, in practice, depend on the extent to which an FHC is engaged in functionally regulated activities; those relationships will also be influenced by existing working arrangements between the Board and the functional regulator. The Federal Reserve's supervisory oversight role is that of an umbrella supervisor concentrating on a consolidated or group-wide analysis</p>
12.	Capital Adequacy norms for FHCs	<p>The FRB has issued comprehensive guidelines on capital adequacy applicable to the BHCs. It may be mentioned that these are in addition to the capital adequacy requirement for the regulated entities under BHC on a standalone basis. The minimum CRAR for BHC has been set at 8%. The BHCs are also subject to consolidated supervision.</p>
13.	Other aspects of regulation of BHCs/FHCs	<p>Other aspects of regulation of BHCs/FHCs in the USA include:</p> <ul style="list-style-type: none"> • Corporate practices of BHCs/FHCs • Registration, reports and inspections • Penalty for violations • Acquisitions by BHCs/FHCs • Permissible non-banking activities • Prohibited activities • Appointment of directors and senior executives
14.	Differential regulation and supervision of different types of BHCs/FHCs	<p>Supervision of BHCs/FHCs is essentially the consolidated supervision of the banking group. For supervisory purposes, FRB broadly classifies BHCs in the following categories:</p> <ul style="list-style-type: none"> • Noncomplex BHCs with Assets of \$1 Billion or Less (Shell Holding Companies) • Noncomplex BHCs with Assets Greater Than \$1 Billion

		<ul style="list-style-type: none"> ➤ One-Bank Holding Companies ➤ Multibank Holding Companies <ul style="list-style-type: none"> • Complex BHCs • Nontraditional BHCs <p>The determination of whether a holding company is “complex” versus “noncomplex” is made at least annually on a case-by-case basis taking into account and weighing a number of considerations, such as the size and structure of the holding company; the extent of intercompany transactions between depository institution subsidiaries and the holding company or non-depository subsidiaries of the holding company; the nature and scale of any non-depository activities, including whether the activities are subject to review by another regulator and the extent to which the holding company is conducting Gramm-Leach-Bliley–authorized activities (e.g., insurance, securities, merchant banking); whether risk-management processes for the holding company are consolidated; and whether the holding company has material debt outstanding to the public. Size is a less important determinant of complexity than many of the factors noted above, but generally companies of significant size (e.g., assets of \$10 billion on balance sheet or managed) would be considered complex, irrespective of the other considerations.</p> <p>The shell companies are generally those which depend upon the board and staff of the lead institution within the group for performing the responsibilities of the parent holding company. FRB uses the term ‘shell’ to refer to only the non-complex BHCs with consolidated assets below USD 1 billion. The framework for consolidated supervision of these BHCs is slightly different and depends to a great extent on the supervision of the lead institution.</p>
15.	Elements of Supervision of BHCs/FHCs	<ul style="list-style-type: none"> • Consolidated Supervision of Bank Holding Companies. • Supervision of Subsidiaries by the BHC/FHC including supervision of their funding policies, loan administration, investments, consolidated planning process, sharing of facilities and staff by various entities within the banking organization, private banking functions. • Intercompany transactions including transactions with the affiliates, sale and transfer of assets, audit, budget, insurance etc.

		<ul style="list-style-type: none">• Non-banking activities of BHCs (including that of their subsidiaries).• Financial analysis of the BHCs/FHCs.
--	--	---